

# **High Technology Tax Update: Actions of 1/1/99 - 1/12/00**

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## **Top Ten Tax Issues for High Tech Industries**

1. Research Tax Credit
2. Capitalization
3. Treatment of High Tech Items  
(such as expensed R&D, software license income)
4. ISOs and ESPPs and Continued Application of  
Revenue Ruling 71-52
5. Worker Classification
6. Defining and Testing Nexus Theories  
(particularly in the e-commerce arena)
7. Taxation of E-Commerce
8. International Tax Developments and Issues
9. Modernizing the Tax Law for Today's Economy and Technology  
(recovery periods, international competitiveness, treatment of  
intangibles, etc.)
10. Non-Tax Developments That May Have Tax Relevance  
(personal jurisdiction, classification of new assets such as domain  
names, expanded bandwidth, privacy issues, Internet regulation,  
and activities of SEC and FASB)

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## REPORTS AND NEWS FROM THE ADMINISTRATION AND THE JOINT COMMITTEE ON TAXATION

**1. IRS Leadership**—On July 14, 1999, the IRS announced that Larry Langdon, Vice President of Tax, Licensing and Customs for Hewlett Packard would become the Commissioner of the new Large and Mid-Size Business Division in December. Deborah Nolan, with the IRS since 1972, will be the Deputy Commissioner. [IR-1999-62]

### **2. IRS Audit Guidelines**

**a. MSSP for High Tech Companies**—In March 1998, the Service released a Market Segment Specialization Program paper—Computers, Electronics, and High Tech Industry. This document provides examination guidelines and suggestions for revenue agents in the following areas:

- Inventory and cost of sales
- Research and development
- Deferred revenue
- International issues

Portions of the paper are outdated. The paper can be obtained at the IRS Web site:

[http://www.irs.ustreas.gov/prod/bus\\_info/tax\\_mssp.html](http://www.irs.ustreas.gov/prod/bus_info/tax_mssp.html)

**b. Research Credit and Other ISP Papers**—Two new coordinated issues papers were released in 1999, both dealing with the research credit. Both are viewed as controversial and not in line with legislative history behind §41. Some of the controversial portions of the December 1998 *proposed* regulations (REG-105170-97) are used in the 1999 ISP papers. These and other Industry Specialization Program papers for the Data Processing Industry are available at the IRS web site at:

[http://www.irs.gov/prod/bus\\_info/tax\\_pro-coord.html](http://www.irs.gov/prod/bus_info/tax_pro-coord.html)

- i. Qualifying Wages under Section 41 in Determining the Tax Credit for Increasing Research Activities (2/16/99)
- ii. Research Credit - Internal Use Software (8/26/99)

- iii. Research Credit - Qualified Research (8/26/99)
- iv. Capitalization of Lease Related Expenses (7/31/92)
- v. Wages of Technical Writers and the R&E Credit (7/31/92)

**3. Tax Shelter Studies**—In July 1999, the Treasury Department released a report, *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals*.<sup>1</sup> The Treasury Department would like to provide a "generic solution to curb the growth of corporate tax shelters" rather than just dealing with them after-the-fact. (Discussed later in outline.)

In November, the Joint Committee on Taxation issued a tax shelter report as an appendix to testimony presented before the House Ways and Means Committee on November 10, 1999. See JCX-84-99, Appendix II to JCX-82-99: *Description and Analysis of Present-Law Tax Rules and Recent Proposals Relating To Corporate Tax Shelters*.<sup>2</sup>

**4. Penalty and Interest Study**—In July 1999, the Joint Committee on Taxation issued a legislatively-mandated report on penalty and interest provisions (JCS-3-99). This report also provides suggestions for using the penalty system to cut down on the proliferation of corporate tax shelters.

## DETAILS OF AUTHOR'S TOP 10 LIST

### Research Tax Credit

**5. Extension, Modification, and Clarification of the Research Tax Credit**—The Tax Relief Extension Act of 1999 (P.L. 106-170; December 17, 1999) extends the research credit through June 30, 2004. It also expands the credit to include research undertaken in Puerto Rico and U.S. possessions. This Act also increases each of the three percentages used to compute the alternative incremental research credit (AIRC) by one percentage point (to 2.65, 3.2, and 3.75). A final change to §41 provides that credits attributable to the period beginning July 1, 1999 and ending September 30, 2000 may not be used for any purpose prior to October 1, 2000. Subsequent to that time, the credit may be taken into account on amended returns, an application for expedited refund (see below), an estimated tax adjustment, or other means allowed by the Code. Despite the delay in claiming the credit, a taxpayer's §174 deduction must still be reduced by the credit applicable to that period (unless the taxpayer elects to take a reduced credit under §280C(c)). Also, the prohibition "extends to the determination of any penalty or interest under the Code." A similar delay applies to any credit attributable to the period beginning October 1, 2000 and ending September 30, 2001 such that any credit attributable to that period may not be taken into account for any purpose (other than §280C(c)) prior to October 1, 2001.

Helpful text of the TREA'99 regarding the suspension period follows (Act §502(d)(3) & (4)):

"(3) *EXPEDITED REFUNDS*.—

(A) *IN GENERAL*.—If there is an overpayment of tax with respect to a taxable year by reason of paragraph (1) [general rule prohibiting use of credit during suspension period], the taxpayer may file an application for a tentative refund of such overpayment. Such application shall be in such manner and form, and contain such information, as the Secretary may prescribe.

(B) *DEADLINE FOR APPLICATIONS*.—Subparagraph (A) shall apply only to an application filed before the date which is 1 year after the close of the suspension period to which the application relates.

(C) *ALLOWANCE OF ADJUSTMENTS*.—Not later than 90 days after the date on which an application is filed under this paragraph, the Secretary shall—

- (i) review the application,
- (ii) determine the amount of the overpayment, and
- (iii) apply, credit, or refund such overpayment,

<sup>1</sup> Available at <http://www.ustreas.gov/taxpolicy/>.

<sup>2</sup> See <http://www.house.gov/jct/pubs99.html>.

in a manner similar to the manner provided in section 6411(b) of such Code.

(D) *CONSOLIDATED RETURNS.*—The provisions of section 6411(c) of such Code shall apply to an adjustment under this paragraph in such manner as the Secretary may provide.

(4) *CREDIT ATTRIBUTABLE TO SUSPENSION PERIOD.*—

(A) *IN GENERAL.*—For purposes of this subsection, in the case of a taxable year which includes a portion of the suspension period, the amount of credit determined under section 41 of such Code for such taxable year which is attributable to such period is the amount which bears the same ratio to the amount of credit determined under such section 41 for such taxable year as the number of months in the suspension period which are during such taxable year bears to the number of months in such taxable year.

(B) *WAIVER OF ESTIMATED TAX PENALTIES.*—No addition to tax shall be made under section 6654 or 6655 of such Code for any period before July 1, 1999, with respect to any underpayment of tax imposed by such Code to the extent such underpayment was created or increased by reason of subparagraph (A)."

*Clarification of TRA'86 legislative language:* Just as Congress did when it last extended the credit in October 1998, it included language in the conference committee report to help define key terms in defining "qualified research." The full text of this language follows:<sup>3</sup>

"In extending the research credit, the conferees are concerned that the definition of qualified research be administered in a manner that is consistent with the intent Congress has expressed in enacting and extending the research credit. The conferees urge the Secretary to consider carefully the comments he has and may receive regarding the proposed regulations relating to the computation of the credit under section 41(c) and the definition of qualified research under section 41(d), particularly regarding the "common knowledge" standard. The conferees further note the rapid pace of technological advance, especially in service-related industries, and urge the Secretary to consider carefully the comments he has and may receive in promulgating regulations in connection with what constitutes "internal use" with regard to software expenditures. The conferees also observe that software research, that otherwise satisfies the requirements of section 41, which is undertaken to support the provision of a service, should not be deemed "internal use" solely because the business component involves the provision of a service.

The conferees wish to reaffirm that qualified research is research undertaken for the purpose of discovering new information which is technological in nature. For purposes of applying this definition, new information is information that is new to the taxpayer, is not freely available to the general public, and otherwise satisfies the requirements of section 41. Employing existing technologies in a particular field or relying on existing principles of engineering or science is qualified research, if such activities are otherwise undertaken for purposes of discovering information and satisfy the other requirements of section 41.

The conferees also are concerned about unnecessary and costly taxpayer record keeping burdens and reaffirm that eligibility for the credit is not intended to be contingent on meeting unreasonable record keeping requirements."

Some of the issues raised by commentators on the December 1998 proposed §41 regulations (REG-105170-97) include:

- i. The definition of gross receipts as amounts from all activities and from all sources seems too broad. This broad definition will cause some "start-ups" to not meet the definition of a start-up taxpayer under §41 that is entitled to a fixed 3% fixed-base percentage (a lower fixed-base percentage is advantageous).
- ii. Defining "discovering information" as obtaining knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of technology or science, is too broad and is a subjective standard because of the reference to "skilled professionals."
- iii. The definition of "process of experimentation" does not follow the legislative history: (*emphasis added*)  
Prop. §1.41-4(a)(5)—"a process to evaluate more than one alternative designed to achieve a result where the means of achieving that result are uncertain at the outset. A process of experimentation in

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<sup>3</sup> Cong. Rec. November 17, 1999, page H12207.

the physical or biological sciences, engineering, or computer science *requires* that the taxpayer--(i) Develop one or more hypotheses designed to achieve the intended result ..."

TRA'86 Blue Book (page 133)—"a process involving the evaluation of more than one alternative designed to achieve a result where the means of achieving that result is uncertain at the start. This *may* involve developing one or more hypotheses, testing and analyzing those hypotheses ..."

**6. §41 and Members of a Controlled Group**—On January 4, 2000, the IRS issued proposed regulations (REG-105606-99) on changes to §41 made by the RRA'89 and the SBJPA'96 on the computation of the research tax credit and alternative incremental research credit (AIRC) for members of a controlled group. Section 41(f) provides that the credit for members of a controlled group is computed by treating all members as a single taxpayer. The group credit is to be allocated among the members based on the proportionate share of the qualified research expenses and basic research payments of each member. The regulations serve to clarify that the credit should be allocated among members by considering the credit's incremental nature. Per the preamble, some taxpayers had interpreted the removal of the word "increase" from §41(f) by the RRA'89 as indicating that the credit be allocated based on gross research expenditures of each member. Treasury and the IRS believe that removal of "increase" was only due to the change in computation of the credit, and did not signify that its incremental nature should be ignored. The proposed regulations should be reviewed for the mechanics of the credit calculation and allocation among members; several examples are included in the regulations.

The regulations are proposed to be effective for tax years ending on or after January 4, 2000. They are also "proposed to be retroactive in certain limited circumstances to prevent abuse. To prevent taxpayers that are members of a controlled group from together claiming in excess of 100% of the credit with respect to prior taxable years, the rules for allocating the group credit would apply to any taxable year beginning after December 31, 1989, in which, as a result of inconsistent methods of allocation, the members of a controlled group as a whole claimed more than 100% of the allowable group credit. In the case of a group whose members have different taxable years and whose members used inconsistent methods of allocation, the members of the group as a whole shall be deemed to have claimed more than 100% of the allowable group credit."

Query: Why weren't the regulations issued as temporary regulations, rather than only as proposed regulations?

**7. Qualified Research and Special Rules for Internal Use Software**—In *United Stationers, Inc. v. U.S.*, 99-1 USTC ¶150,136, 82 AFTR2d 98-7488 (7th Cir.), *cert. denied* S.Ct. Dkt. No. 98-1870 (6/21/99), the district court denial of a research tax credit for eight internal use software programs was affirmed. USI had purchased a software package to be modified to meet its needs for various internal purposes, such as tracking inventory. To qualify for the credit, USI not only had to meet the four requirements of "qualified research" under §41(d) (explained in the following chart), but also had to show that the research met the additional requirements for internal-use software.

Test	Analysis
1. The research must qualify as R&E under §174.	Not contested by the Service.
2. The research must be undertaken to discover information that is technological in nature.	Not met. The lower court had focused on the dictionary definition of "discover." The 7th Circuit stated that they did not adopt this view that this test turns on the breadth of the definition of "discover." The court, with reference to <i>Norwest</i> , 110 T.C. 454 (1998), stated that "qualifying research must go beyond the current state of knowledge in that field - expand or refine its principles. ... discovery demands something more than mere superficial newness; it connotes innovation in underlying principle. ... Congress clearly intended, ..., that qualifying research pass a high threshold of innovation and be of broad effect." The court also noted that this interpretation was in line with the original 1981 and modified 1986 purpose of the research credit.

<p>3. The taxpayer must intend to use the information to develop a new or improved business component.</p>	<p>The Service conceded that this test was met.</p>
<p>4. The taxpayer must pursue a "process of experimentation" during substantially all of the research.</p>	<p>Not met. The court stated that the legislative history to §41 was to be interpreted to indicate that a process of experimentation involved more than just debugging a computer program. "USI would have us hold that [H.R. Conf. Rep. No. 99-841] dictates a per se credit for software development. This suggestion, however, ignores the Report's mention of only SYSTEMS design (not SOFTWARE design) as well as its focus on overcoming design uncertainty through a systematic - almost scientific - methodology. The Report suggests that qualifying research must from its outset involve some technical uncertainty about the possibility of developing the product." The court also noted that USI's summary description of each program only noted the uncertainty of realizing the expected operational efficiencies; they did not describe any technical uncertainty of creating the programs—"there was no technical uncertainty from the outset."</p>

*Internal-use software:* USI argued that the §41 exclusion for internal use software (which imposes additional tests that must be met for the qualified research expenditures to qualify for the credit), only applies to software that is intended exclusively for internal use. Per USI, the legislative history refers to software for general and administrative functions or in providing noncomputer services, while USI's software related to its core business activities. USI posited that its programs, such as for inventory control, are integral to its core revenue activities as a wholesale distributor. The court disagreed with this analysis—even programs to which USI customers had access served the purpose of streamlining USI's operations. The programs did not fall within the congressional purpose for creating the credit.

The lower court concluded that USI met both the innovative and not commercially available tests for internal use software, but not the significant economic risk test. The 7th Circuit agreed holding that the programs did not involve the "requisite technical risk." "[W]e can be confident that because USI's projects did not meet the less demanding general requirements of section 41's qualified research definition, they necessarily do not pass the higher threshold of risk required by the exception to the internal use exclusion."

Comments: (1) *Qualified research:* The 12/24/98 7<sup>th</sup> Circuit decision made no reference to the TTREA'98 legislative history which clarified the terms "technological in nature" and "process of experimentation." Arguably, USI was engaged in making evolutionary improvements to the functionality and performance of the canned software it began with. Perhaps the emphasis on the "discovery test" is better explained as to whether or not USI was engaged in research activities, or mere programming/writing of code. Both the statute (§41(d)(3)(E)) and legislative history use the term "research with respect to computer software which is developed ...," rather than just using the term software development. What is the difference, if any, between "research with respect to software" and software development?<sup>4</sup> Unfortunately, the USI opinions do not delve into the nature of the work performed by the software developers and the terms "research" and "development."

Note that for Test #4, the Court states that the original legislative history suggests that qualifying research must involve some technical uncertainty about the possibility of developing the product. In contrast, the October 1998 legislative clarification provides that a process of experimentation requires that the means of achieving a result are uncertain, "even if the taxpayer knows at the outset that it may be technically possible to achieve the result."

(2) *What is internal-use software?* Is a better definition of "internal use software" needed? Prop. §1.41-4(e)(1) states: "Research with respect to computer software that is developed by (or for the benefit of) the taxpayer primarily for the taxpayer's internal use is eligible for the research credit only if the software satisfies the requirements of paragraph (e)(2) of this section. Generally, research with respect to computer software is not eligible for the research credit where software is used internally, for example, in general and administrative

<sup>4</sup> One of the Service's experts in *Norwest, supra*, noted the difference between software development and research. Software research involves a search for information, use of test data, and the presence of technical risk. Software development involves the production of code, use of production data, and failure is more likely to be due to people and project management risks, rather than technical risk.

functions (such as payroll, bookkeeping, or personnel management) or in providing noncomputer services (such as accounting, consulting, or banking services)." This language echoes that in the 1986 Blue Book (pages 134-135).

Statement of Position (SOP) 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* (3/4/98), defines internal-use software as "acquired, internally developed, or modified solely to meet the entity's internal needs" and "during the software's development or modification, no substantive plan exists or is being developed to market the software externally" [¶12]. The SOP lists four types of software: 1) software to be sold, leased, or otherwise marketed as a separate product or as part of a product or process (costs to be treated per FAS #86), 2) software for use in R&D (costs to be treated per FAS #2 and FAS Interpretation #6), 3) software developed for others under a contract (costs to be treated per contract accounting rules), and 4) internal-use software (costs to be treated per SOP 98-1) [§6]. The appendix to SOP 98-1 contains 13 examples of internal-use software, as well as 8 examples of software that is not for internal use. The focus of the SOP definition of internal-use software is on whether the software is to be marketed to customers, rather than whether customers might use it in some manner. Example 10 in the SOP Appendix provides that a software database developed by a broker-dealer entity which then charges for financial information distributed through the database is internal-use software.

While the SOP definition of internal-use software, which basically looks at whether there was a primary intent to market the software or just use it internally, is fairly clear, would such a definition satisfy the congressional intent in creating the research credit and the carve-out for certain internal use software under §41? Certainly, Congress could have carved out all internal-use software development costs from the credit and provided a definition as used in the SOP, but it did not. Instead, it provided certain tests that, if met, would allow the research costs to potentially qualify for the credit.<sup>5</sup> Congress used the phrase, "research with respect to computer software that is developed by (or for the benefit of) the taxpayer *primarily* for the taxpayer's own internal use" (emphasis added; 1986 Blue Book page 134). Perhaps this language was used with the intent of §41 in mind because certain software, even though not marketed by a taxpayer, might "increase the innovative qualities and efficiency of the U.S. economy" [1986 Blue Book page 130].

(3) *What is the status of regulations under §41 as changed by the TRA'86?* Are any changes expected to the internal use software proposed regulations issued in December 1996? What about the proposed §41 regulations issued in December 1998 (REG-105170-97).

(4) *Should limitation of the credit under the TRA'86 requirements be through market forces or IRS scrutiny of what is a new discovery?* Did Congress intend for the research credit to only be available where the taxpayer can show that it discovered something that was new to everyone? Did Congress intend that software development would have to expand or refine the field of computer science, or somehow go beyond the preexisting knowledge of the principles of computer science? Who is to make this determination—does the Service have the ability to make this level of scientific/engineering determination? Isn't the "deemed" language of the legislative history intended to prevent a need for the Service to make such a determination?—

"The determination of whether the research is undertaken for the purpose of discovering information that is technological in nature depends on whether the process of experimentation utilized in the research fundamentally relies on principles of the physical or biological sciences, engineering, or computer science<sup>23</sup>—in which case the information is deemed technological in nature—or on other principles, such as those of economics—in which case the information is not to be treated as technological in nature." [TRA'86 Blue Book page 133]

<sup>23</sup> Research does not rely on the principles of computer science merely because a computer is employed. Research may be treated as undertaken to discover information that is technological in nature, however, if the research is intended to expand or refine existing principles of computer science.

<sup>5</sup> Meeting the "three tests" (innovative, significant economic risk, and not commercially available) are not the only ways that research with respect to internal-use software might qualify for the credit. Also potentially eligible are "(1) qualified research (other than the development of the internal-use software itself) undertaken by the taxpayer, or (2) a production process that meets the requirements for the credit (e.g., where the taxpayer is developing both robotics and software for the robotics to be used in a manufacturing process, and the taxpayer's research costs of developing the robotics are eligible for the credit).

Does the "deemed" language imply a separate discovery test, or does it just provide that if the research is in an appropriate field, it is deemed technological in nature (which along with the other requirements and limitations of §41, ensures that the credit is allowed only for the appropriate expenses and research activities)?

Given that many software processes are protected by trade secret, how can a taxpayer know if they have expanded the field of computer science?

Did Congress use a tax credit rather than direct research grants to allow for market forces and industry knowledge to operate to ensure that government funds not go to the "wrong" projects?

**8. Internal Use Software Claims**—Chief Counsel Notice N(35)000-161 issued in May 1999 provides information to examiners on coordinating the Service's efforts in handling these claims. The Notice states that there are 12 cases in Tax Court and over 200 cases in examination with the issue of the research credit claimed for internal-use software. The Service also describes the *Norwest* case as a victory (even though the taxpayer won on the largest project). The Service is attempting to develop additional precedent in Tax Court and requests personnel in the Chief Counsel's office handling these issues to be sure the National Office knows.

**9. Severance/Separation Pay**—One of the gray areas in application of the research tax credit (and an IRS audit issue as well) is whether severance pay made to a researcher should be included in calculating qualified research expenses (QRE) subject to the credit. A 1999 case, although not involving the research credit, may provide some guidance in this area as well. *Abrahamsen, et al v. U.S.*, 84 AFTR2d 99-5293 (Fed. Cls.), held that payments made to employees by IBM in a downsizing initiative were wages for FICA purposes. IBM had had the employees sign releases not to sue for discrimination in accepting the severance pay. The calculation of the severance pay was the same for all downsized employees and most employees had never brought any discrimination complaint against IBM in the past. Also, if a departing employee returned to IBM, a prorated portion of the severance pay had to be returned to IBM. The employees sought to have taxes on the payments returned on the basis that the payments were excludable because made on account of injury. The court rejected this argument based on prior interpretations of §104. The employees also argued that FICA was not applicable because the severance pay was not remuneration for services. The court held for the Service based on an interpretation of §3102(a) and §3121(a). Per §3121(a), "wages" subject to FICA means "all remuneration for services." Section 3121(b) defines "employment" as "any service, of whatever nature performed by an employee for the person employing him."

"Wages" that potentially qualify for the research tax credit must be wages per §3401(a). This provision defines "wages" as all remuneration for services performed by an employee for his employer. Thus, both the §3121 and §3401 definitions of "wages" refer to services performed by an employee for his employer. In the IBM case, the court focused on the formula for determining the severance amount. Where the formula considers length of service and rate of pay, the court found such a payment to constitute wages.

A fact pattern that sounds like it could be the IBM situation was addressed in FSA 199931012 that specifically addressed the research credit issue. The Service ruled that the separation payments were not excludable because they were not based upon tort or tort-type rights. Also, a payment made by an employer to an employee for involuntary separation from service is wages even if the employer is not legally obligated to make the payment. A payment does not have to be made in return for actual services performed in order to be wages for FICA purposes. The Social Security Act interpretation of wages is "all remuneration for employment" unless specifically excepted. Since the payments were based on length of service and the employee's salary at the time of separation, the payments appeared to be wages. Next, the Service ruled that for employees who performed qualified services while employed by the employer, the separation payments constituted "qualified research expenses" for purposes of calculating the research tax credit.

**10. QRE Calculation is Not an Accounting Method**—On its Year 1 return, Partnership (P) calculated the research credit at the partnership level and then passed it through to its partners. It later amended the return and changed from passing the credit through to instead passing through each partner's share of qualified research expenses (QRE) so each partner could calculate their own credit. The Service made reference to §1.41-9(a)(3) and §1.41-2(a)(4) in how the credit is to be calculated for a partnership and concluded that P should have calculated the credit at the partnership level and passed it through. The Service also held that P's change in treatment of the credit was not a change in method of accounting because it did not involve the proper time for including an item in income or taking a deduction. [FSA 199908004 (11/17/98)]

**11. IRS Needs R&E Consultants**—BNA Tax Management Weekly Report (3/29/99, page 556) noted that at a March 18 Corporate Counsel Institute sponsored by Georgetown Law School, the IRS assistant commissioner of exams said that the Service would be hiring six new outside consultants to assist the IRS in working its research credit cases. The Service needs more expertise to deal with the \$2 billion in pending refund claims.

## Capitalization

The meaning of the 1992 Supreme Court decision in *Indopco* continues to be an audit issue and item on the IRS Business Plan. Below are selected recent rulings involving whether a particular expenditure should be expensed or capitalized. Recent guidance under §195 on start-up expenditures is also covered in this section.

**12. Service Calls *Indopco* a "Sensitive" Case**—In FSA 1999-433 (1999 TNT 25-21), the Service states:

- "Since items are deductible under *Lincoln Savings* if certain conditions are met, 403 U.S. at 352, we should not cite *INDOPCO* to support capitalization of an item which would have been deductible under these conditions before the case was handed down."
- "*INDOPCO* remains a sensitive case because of its potential to require capitalization of a broad range of expenses previously allowed as deductions. Until the Service and the Treasury have refined their interpretation of the case, we recommend *INDOPCO* not be cited as the principal authority requiring capitalization. Should the treatment of supply contract modification expenses proceed to litigation if it is not settled as you have already indicated has occurred, the section 263 argument outlined in our previous advice should be the primary argument."

**12. Real Estate Development Costs**—In FSA 1999-1088 the IRS held that costs of obtaining building permits, negotiating permit fees, performing engineering and feasibility studies, and drafting landscape and architectural plans for real property acquired for production had to be capitalized under §263A. In addition, the real estate taxes on the property acquired for production must also be capitalized. However, interest on debt used to pay the real estate taxes are not capitalizable until production begins.

**13. Environmental Remediation Costs**—In TAM 199952075, the Service held that a utility company was entitled to currently expense the costs of cleaning contamination that occurred while it owned the property. However, it must capitalize clean-up costs allocable to contamination that occurred prior to its acquisition of the property. The revenue agent had questioned the company's expensing of clean-up costs because the company had also constructed a new building on the site. However, the IRS National Office noted that the clean-up costs, by themselves, did not adapt the property to a new or different use. The costs merely restored the property to its condition when the company acquired it. Similarly, the Service did not find that the clean-up costs had to be capitalized as land preparation costs because the costs did not improve or substantially change the property. "Similarly, although the cleanup arguably was undertaken to permit or at least to facilitate construction of the new building, we do not believe the cleanup expenses in the present case represent a cost of the new building. Instead, even assuming arguendo that Taxpayer's cleanup is properly characterized as a land preparation activity, the costs would relate to and be includible in the basis of the land, not the new building, because the 'land preparation' in the present case will not be retired, abandoned, or replaced contemporaneously with the building." But, the Service did not find that the costs were for land preparation.

**14. Costs of Entering Long-Term Customer Contracts**—In TAM 199952069, the Service held that T must capitalize the employee compensation and travel costs associated with soliciting, evaluating, and negotiation five long-term service contracts. The Service found that capitalization was warranted both because T was acquiring a long-lived asset and was receiving a significant long-term benefit. The Service addressed T's four arguments for expensing as follows.

<i>Taxpayer</i>	<i>Service</i>
A. The costs are deductible selling expenses. Selling expenses as defined under §1.451-3(d)(5)(iii)(A) includes bidding expenses.	The §451 regulations do not address timing of deductions under §162 and §263.
B. The expenditures are recurring ones. Also, a separate and distinct asset has not been created because T must perform substantial services to generate revenue from the contracts.	The holding in <i>FMR Corp.</i> , 110 T.C. 402 (1998), supports capitalization of costs to create a contract with provide the taxpayer with a significant long-term benefit.
C. The contracts are self-created intangible assets and per the legislative history to §197, the costs are currently deductible.	The legislative history to §197 does not support changing the treatment of costs to acquire or create assets.

D. Costs incurred prior to the bid award date are deductible as investigatory costs.	Per <i>Norwest</i> , 112 T.C. No. 9 (1999), preparatory costs incurred before a formal decision to proceed with a transaction are still related to the capital transaction.
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**15. APA Fees**—TAM 1999929038 held that a taxpayer could expense consulting fees incurred in developing a transfer pricing methodology and negotiating an advance pricing agreement (APA). Taxpayer's goal was to use the APA for both prior years (under audit) and two future years. The National Office held that since the primary benefit of the APA was to reduce future compliance costs, capitalization was not warranted: "the reduction of future costs, without more, is not a sufficient ground for capitalization." Neither did the Service find that a separate and distinct asset was created or that the fees related to a capital transaction.

**16. ISO 9000 Certification Costs**—Rev. Rul. 2000-4, 2000-4 I.R.B. \_\_\_, holds that costs to obtain, maintain and renew ISO 9000 certification are deductible under §162. The Service concluded that the benefits derived from ISO 9000 certification are incidental and similar to current benefits of training, advertising and expenditures incurred to retain existing customers or to just improve the overall quality or attractiveness of the taxpayer's business operations. Per the Service, "these future benefits are incidental to the primary benefit of current sales" and are therefore currently deductible. The Service also referred to the *Briarcliff Candy* case (475 F.2d 775 (2d Cir.)) and *Sun Microsystems* (T.C. Memo 1993-467) to support its §162 conclusion in that the "mere ability to sell in new markets and to new customers, without more, does not result in significant future benefits." In addition, the Service stated that ISO 9000 certification is not like obtaining a license or certification that is necessary for market-entry (which would most likely be capitalizable). Finally, the Service noted that if any asset with a life greater than one year, such as a quality manual or equipment, was created or acquired in the certification process, the cost of such item would have to be capitalized.

Taxpayers needing to change their accounting method for ISO 9000 costs may use the automatic change procedure of Rev. Proc. 99-49, 1999-52 I.R.B. 725.

*History:* In 1997, the Service informally circulated a paper detailing its position on the tax treatment of costs to obtain ISO 9000 certification.<sup>6</sup> The Service's position was that all internal and external costs associated with an initial ISO 9000 certification, plus costs of triennial audits must be capitalized. This position was based on an application of *Indopco*, the view that such certification provided a membership extending beyond the year of payment, and the time period associated with the triennial audits.

**17. Systems Upgrade Expenditures**—While there is no specific case or IRS ruling on the treatment of costs to install and implement database software (referred to by the Service as "Enterprise Resource Planning" (ERP) systems), it is an audit issue for the Service and we may see a TAM in the future. The typical fact pattern is where a taxpayer has purchased a database software system, such as Oracle or SAP, and has hired a consultant to integrate the package into existing systems and to improve the operating systems of various departments, such as production, human resources, accounting, and sales. Revenue Agents will tend to label this type of work as management consulting which does not qualify as an R&E deduction under §174. They will also likely argue that Rev. Proc. 69-21 does not apply because no software development is taking place. Instead, templates are used and pre-set programs. In addition, agents will categorize the expenditures as §263 because of the long-term benefits expected by the taxpayer.

## **18. Business Expansion, §195, *Briarcliff Candy*, §162 and §263(a)—Recent Activities**

**a. Costs to develop new type of life insurance product**—T deducted costs incurred to develop a new type of life insurance policy. The costs included wages, travel, training, and legal and accounting fees to obtain SEC approval, develop underlying actuarial assumptions, enhancing software and preparing training and marketing materials. Under the policy, the build-up is invested in mutual funds and thus, can only be sold by insurance agents who are also licensed stockbrokers. The Service described T's situation as expansion of a business that creates a significant long-term benefit, thus requiring capitalization of the expenditures. The Service also noted that it did not matter whether T was trying to improve service to its existing market or to tap a completely new market. Relying on *Central Texas Savings & Loan*, 731 F.2d 1181 (5th Cir. 1984) and *Cleveland Electric Illuminating Company*, 7 Cl. Ct. 220 (1985), the Service stated that "expenses to establish a new product are capital if the new product is vastly different from existing products." The Service

<sup>6</sup> The paper was reprinted in McGraw-Hill's *Quality Systems Update*, March 1997 special supplement.

distinguished *Briarcliff Candy*, 475 F.2d 775 (2d Cir. 1973) which held that a taxpayer could expense costs of finding new ways of selling its existing product (however, this decision did rely partially on what is now known (per *Indopco*) to be an erroneous interpretation of the *Lincoln Savings* case). "Briarcliff Candy can be distinguished on the grounds that it involved expenses incurred to market the company's existing products differently." There was no discussion in the TAM as to the application of §195 (presumably because T did not make a §195 election). [FSA 1999-1105]

Comment: It is interesting to note that the Service took the effort to distinguish *Briarcliff Candy* from the taxpayer's facts rather than just taking a position (as taken by some courts) that *Briarcliff* is outdated after *Indopco*.

**b. Preacquisition salaries**—In *Norwest Corp., et al. v. Commissioner*, 112 T.C. No. 9 (1999), Davenport Bank and Trust Co. (DBTC) deducted \$474,018 of investigatory and due diligence costs, and \$150,000 of officers' salaries incurred in investigating a merger which actually took place causing DBTC to merge with a Norwest subsidiary. Norwest conceded that only about \$111,000 of the \$474,000 should have been deducted. Such costs were incurred in investigating Norwest to determine if it would be a good fit with DBTC, such costs did not relate to negotiating a price or satisfying securities law requirements. The Service argued that all costs, including the salaries should be capitalized under an *Indopco* argument. Norwest argued that *Indopco* was not controlling as it did not overrule a long line of cases, such as *Briarcliff Candy* (475 F.2d 775 (2d Cir. 1982)) and *NCNB Corp.* (684 F.2d 285 (4th Cir. 1982)) which allowed a deduction for investigatory and due diligence costs incurred in expanding an existing business. Norwest also argued that §195 supported deducting these costs.

The Tax Court held for the Service based on i) *Indopco*; ii) the interpretation that *Indopco* "displaced the body of law set forth in *Briarcliff Candy* and its progeny insofar as they allowed deductibility of investigatory costs in a setting similar to that at hand; i.e., where an expenditure does not create a separate and distinct asset;" iii) proper matching of expenses and related income; and iv) the interpretation of §195 that it "does not require that EVERY expenditure incurred in ANY business expansion is to be currently deductible" (quoting *FMR, supra*). The court also referred to two earlier cases involving takeovers, *Victory Mkts.* (99 T.C. 648 (1992)) and *A.E. Staley* (119 F.3d 482 (7th Cir. 1997)). The court did not agree with Norwest that costs incurred investigating an expansion prior to formally deciding to engage in a transaction were deductible. The court viewed such expenditures as merely preparatory to enabling DBTC to achieve the long-term benefit it desired and all such costs are sufficiently related to the actual acquisition/merger to be capitalizable.

Comment:

Is *Briarcliff Candy*, 31 AFTR2d 73-935 (2d Cir.), still useful? The Second Circuit stated that the Tax Court had created "manifest error" in finding that Briarcliff had to capitalize its costs incurred in getting stores in suburbs to sell its candy on the basis that some of the agreements entered into lasted beyond one year. The court interpreted the following statement from *Lincoln Savings* as meaning that a definite asset had to exist: "What is important and controlling, we feel, is that the [premium] payment serves to create or enhance for [the taxpayer] what is essentially a separate and distinct additional asset." The court did not find that the costs associated with Briarcliff's "ambitious new distribution program" created an asset. The "franchise" agreements with retail stores did not obligate store owners to sell a minimum amount of Briarcliff's candy, and neither did they "guarantee any amount of sales nor limit the owner from selling candy of other suppliers. "There is nothing in the substance of these contracts which is distinguishable from a contract of employment for a term of a year or years. The store proprietors simply became retail sales agents of [Briarcliff] on a commission-paid basis. The expenditures at issue in the case are ordinary recruiting costs to enlist sales agents for a long established concern, and to seek sales agents for its usual and regular product."

The court also stated, "The facts of this case bring it squarely within the long recognized principle that expenditures for the protection of an existing investment or the continuation of an existing business or the preservation of existing income from loss or diminution, are ordinary and necessary within the meaning of §162 and not capital in nature."

Briarcliff did not incur costs to acquire a benefit with a guaranteed income stream. Is the fact that it hired more sales staff, conducted an advertising campaign to independent drugstores, set up a "franchise" division, and entered into "franchise" agreements of one to five years duration with stores, enough to result in capitalization? Given that there is no guarantee of success with this new sales technique, isn't the possibility of any long-term benefit too speculative to require capitalization? Does the apparent formality of a new "franchise" division and "franchise" agreements lead to a capitalization result? If Briarcliff had only hired

more sales staff and sent them to visit retail stores in suburbs would the hiring costs and salaries have to be capitalized?

Didn't Briarcliff Candy just engage in ordinary and necessary business expansion costs? Where is the line to be drawn between §263 and §162? See Rev. Rul. 2000-4 (earlier) that indicates that the Service does find Briarcliff to be still be valid for certain market maintenance and expansion costs.

**C. Revenue Ruling 99-23**—This §195 ruling explains when expenditures incurred in acquiring the assets of an active trade or business qualify as "investigatory" costs eligible for amortization as start-up expenditures under §195. The Service based its conclusion on Rev. Rul. 77-254 which is mentioned in the legislative history to §195. Under this ruling, expenses incurred in a general search for, or an investigation of, a business that pertain to whether to purchase a business and which business to purchase are investigatory costs. "Once a taxpayer has focused on the acquisition of a specific business, expenses that are related to an attempt to acquire that business are capital." The "final decision" mentioned in the §195 legislative history in describing when costs are no longer considered "investigatory" "is the point at which a taxpayer makes its decision whether to acquire a business, and which business to acquire, rather than the point at which a taxpayer and seller are legally obligated to complete the transaction." Since any non-investigatory costs are incurred for a long-term benefit, they must be capitalized. All facts and circumstances are to be considered in determining whether expenditures related to acquisition of a business are "investigatory" costs.

Similarly, see TAM 199901004 (released prior to issuance of Rev. Rul. 99-23) where the Service held that the "whether and which" decision constituted a final decision under §195. Also see TAM 9825005 where the Service stated that the expenses incurred by taxpayer in acquiring a bank indicated that it had "gone beyond a general search or preliminary investigation of Bank 1 and had decided to acquire Bank 1." Thus, the costs had to be capitalized under §263 as acquisition costs, and therefore, cannot be §195 start-up costs.

## Treatment of High Tech Items

**19. Web Banner Ad Swaps**—In IR-2000-03 and Notice 2000-6, 2000-3 I.R.B. \_\_, the IRS announced that it was eliminating the reporting requirement for barter exchanges with respect to transactions involving property or services worth less than \$1.00. This change is effective for transactions reportable on or after January 5, 2000 and before new regulations are issued; thus, no reporting (1099-B) would be necessary for small 1999 transactions. The rationale is that there is "a growing number of barter exchanges that, through the use of electronic or Internet services, engage in millions of transactions daily involving property or services with very low fair market values" and the burden of filing will outweigh the usefulness of the information for revenue purposes. The IRS also seeks comments on how new bartering reporting regulations (§6045) should address whether a per-transaction exception should apply only in situations where an aggregate annual limit is not exceeded, whether annual reporting of certain property or services bartering should be required rather than reporting each transaction separately, and whether any special rules are needed for bartering of electronic or Internet services. Comments are requested by April 4, 2000.

Observation: The type of electronic service that the IRS *seems* to be addressing with the new reporting exception is banner ad exchanges of an inconsequential amount. However, it would be helpful to know how these nominal value exchanges should be valued (since \$.99 and less is almost the equivalent of \$0). For examples of the type of exchanges the Service might be addressing with the exemption, visit (no endorsement intended):

<http://www.pegasoweb.com/pwbanners/banners.html>

<http://www.bannerexchange.com/>

[http://www.adbility.com/ba\\_exchange.htm](http://www.adbility.com/ba_exchange.htm)

More Information: A barter exchange is defined at §6045(c)(3) as "any organization of members providing property or services who jointly contract to trade or barter such property or services." Regulations clarify that an exchange "does not include arrangements that provide solely for the informal exchange of similar services on a noncommercial basis." Per Reg. §1.6045-1(e)(2)(ii) reporting is not required if the barter exchange has fewer than 100 exchanges during a calendar year. Note that bartering done outside of a bartering exchange may still need to be reported on Form 1099-MISC (rather than 1099-B), such as where it is the equivalent of a business paying a contractor with non-cash property totaling \$600 or more for the year. When required, Form 1099-B is due to payees on or before January 31 of the following year.

The penalty for failure to timely file Form 1099-B or to file a 1099-B with incorrect or missing information is provided in §6722. The penalty is \$50 per missed payee 1099-B, with a \$100,000 cap. If the failure is due to intentional disregard, the penalty is the greater of \$100 or 5% of the aggregate amount of the items required to be reported correctly; there is no dollar limitation.

Queries: Why is the de minimis amount so low? Is there more value in processing 1099s for \$1.00 versus \$0.99? Even interest income only needs to be reported on a 1099 if it is \$10 or more. How should these swaps be valued?

Observation: While the exchange values are presumed to be equal (assuming arm's length transactions are involved), the timing of the revenue and expense may not match which would then make a "tax difference" that would necessitate valuing and properly reporting the swap.

**20. Automatic §174(a) <---> (b) Changes**—Rev. Proc. 99-49, 1999-52 IRB \_\_\_, replaces Rev. Proc. 98-60, on the types of changes that qualify for automatic consent for change in accounting method. Rev. Proc. 99-49 continues to treat certain changes from §174(a) to or from §174(b) as an automatic change (prior to Rev. Proc. 98-60, such changes had to be made via the private letter ruling request procedures). An excerpt from Rev. Proc. 99-49 explaining this automatic change and its limitations follows.

SECTION 2A. RESEARCH AND EXPERIMENTAL EXPENDITURES (section 174)

.01 CHANGES TO A DIFFERENT METHOD OR DIFFERENT AMORTIZATION PERIOD.

...

(2) SCOPE.

(a) APPLICABILITY. This change applies to any taxpayer that is changing:

- (i) from treating research and experimental expenditures for a particular project or projects as expenses under section 174(a) to treating such expenditures as deferred expenses under section 174(b), or vice versa;
- (ii) to a different period of amortization for research and experimental expenditures for a particular project or projects that are being treated as deferred expenses under section 174(b); or
- (iii) from treating research and experimental expenditures for a particular project or projects as expenses under section 174(a) or deferred expenses under section 174(b) to treating such expenditures as a capital expenditure under section 263(a), or vice versa.

(b) SCOPE LIMITATIONS CLARIFIED. The scope limitation under section 4.02(6) of this revenue procedure is applied on a project by project basis.

(c) INAPPLICABILITY. This change does not apply to:

- (i) a portion of the research and experimental expenditures paid or incurred for a particular project during the year of change or in subsequent taxable years (that is, the change must apply to all of such expenditures; SEE sections 1.174-3(a) and 1.174-4(a)(5));
- (ii) a change in the treatment of computer software costs under Rev. Proc. 69-21, 1969-2 C.B. 303; or
- (iii) a change in the treatment of Year 2000 costs under Rev. Proc. 97-50, 1997-2 C.B. 525 (but see section 1.02 of this APPENDIX for making this change).

(3) MANNER OF MAKING THE CHANGE.

(a) This change is made using a cut-off method and applies to all research and experimental expenditures paid or incurred for a particular project or projects during the year of change and in subsequent taxable years. SEE section 2.06 of this revenue procedure and sections 174(b)(2), 1.174-3(a), 1.174-3(b)(2), and 1.174-4(a)(5).

(b) The requirement under sections 1.174-3(b)(2), 1.174-3(b)(3), and 1.174-4(b)(2) to file an application no later than the end of the first taxable year in which the different method or different amortization period is to be used is waived for this change. However, see section 6 of this revenue procedure for filing requirements applicable under this revenue procedure.

(c) The consent granted under this revenue procedure satisfies the consent required under sections 174(a)(2)(B), 174(a)(3), 174(b)(2), 1.174-3(b)(2), 1.174-3(b)(3), and 1.174-4(b)(2).

(4) ADDITIONAL REQUIREMENT. A taxpayer must attach to the application a written statement providing:

- (a) the information required in section 1.174-3(b)(2) if the taxpayer is changing to treating research and experimental expenditures as expenses under section 174(a);
- (b) the information required in section 1.174-3(b)(3) if the taxpayer is changing from treating research and experimental expenditures as expenses under section 174(a); or
- (c) the information required in section 1.174-4(b)(2) if the taxpayer is changing from treating research and experimental expenditures as deferred expenses method under section 174(b) or is changing to a different period of amortization for research and experimental expenditures being treated as deferred expenses under section 174(b).

(5) NO AUDIT PROTECTION. A taxpayer does not receive audit protection under section 7 of this revenue procedure in connection with this change.

.02 RESERVED.

**Comments:** (1) Apparently, the reference to "projects" above includes changing an overall R&E method. (2) If a taxpayer wants to change from expensing to capitalization/amortization (or vice versa) for a software development project, Rev. Proc. 99-49 can only be used if the project meets the definition of R&E at §1.174-2. Note that this is also the first hurdle that must be satisfied in order to claim a research tax credit on the software development project.

**21. Assets versus R&E** [§1.174-2(b)]—(1) TAM 199927001—the Service held that costs of constructing molds and other tooling for the manufacture of plastic injection molded products were not §174 R&E expenditures because the costs represented the component parts to create depreciable property. T would only be paid if it successfully designed and built the molds and the customer accepted them. T used the molds after title transferred to customers. Once accepted by the customer, title to the mold shifted to the customer. The Service applied §1.174-2(a) which provides that §174 does not apply to expenditures for the acquisition or improvements of land or depreciable property used in connection with R&E. The Service also applied §1.174-2(b)(4) which provides that §174 does not apply to the costs of component materials or depreciable property or labor and other costs involved in construction, installation acquisition or improvement of property.

"Under the present facts, the expenditures in question are those attributable to the construction of the molds and other tooling. The parties in this case agree that the molds and other tooling are property of a character subject to the allowance for depreciation. It is the Taxpayer's position, however, that such property is not subject to the limitations of section 1.174-2(b)(2) and (4) because the property is not depreciable property "in the hands of Taxpayer. In fact, the plain meaning of the term "property of a character subject to the allowance for depreciation" refers to the character of the property, and not to whether it is depreciable in the hands of a particular taxpayer."

**Observations:** (1) Costs of R&E (rather than the cost of the component parts) should qualify as §174 R&E. (2) Is the Service's interpretation of "property of a character subject to the allowance for depreciation" correct? Does this term refer to the nature of the business property in anybody's hands, or just the taxpayer's hands? How does one distinguish inventory from depreciable property under this interpretation?

(2) FSA 199930016—Taxpayer (T) had contractual arrangements with software developers. Terms included that rights in the works would be with T, T reserved the right to terminate an agreement at any time for any reason, that the work would be merchantable and fit for use on the designated computer system, that the work would not violate any intellectual property laws, and that D would remedy any "bug." The Service held that D's work was not completed under T's order and risk. Thus, T acquired an asset from D, rather than incurred R&E on its own.

(3) *Ekman v. Comm'r.*, 83 AFTR2d 99-2658 (6th Cir.)—the court upheld the Tax Court ruling that the cost of a Porsche engine used by taxpayer to develop a new process was not a §174 deduction because it was a depreciable asset. However, the depreciation on the engine is a §174 expenditure if the engine is used for R&E activities. The taxpayer also lost on his argument that the engine was not depreciable because he intended to "blow it up" in the research. However, five years after acquisition, it was still running and all indications were that it was property subject to wear and tear and thus, depreciable.

**22. Trade or Business of Inventing**—In *Levinson*, T.C. Memo 1999-212, the court held that the taxpayer was not liable for self-employment tax on royalties received from his patents because taxpayer was not engaged in the trade or business of inventing. Taxpayer's inventing activities did not occur on a regular or continuous basis, but were instead, sporadic.

**23. Systems Installation Contracts Are Not Manufacturing**—In FSA 1999-1108, the Service held that contracts to install computer systems were not long-term under §1.451-3(b)(1). Taxpayer was in the business of selling, installing and designing computer systems. T used the percentage of completion method for financial reporting purposes and the completed contract method for tax purposes. The FSA makes no mention of §460 and thus, likely predates the addition of that provision to the Code in 1986. The Revenue Agent took the position that although the contracts took over 12 months to complete, T's activities did not constitute manufacturing. The Service agreed with the Agent based on its revenue rulings holding that contracts for architectural, engineering, construction management and painting services are not long-term contracts (see Rev. Ruls. 84-32, 82-134, and 70-67). One of the rationales behind the rulings is that the taxpayers were not subject

to risks of price changes and losses as a general contractor would be. "Where the taxpayer is not subject to such risks, the completed contract method of accounting is generally not appropriate." The Service also cited PLR 8545007, which held that agreements to provide data processing services were not long-term contracts. This ruling also held that the words, "building, installation, and construction," added to the regulations in 1922, are "in pari materia and, as such, should be construed together to effect the drafter's intent." Thus, "installation" of software is not the type of "installation" contemplated by the regulations.

The FSA also attempts to define the term "manufacturing," relying on a Supreme Court definition from *Anheuser-Busch Brewing Assoc. v. U.S.*, 207 U.S. 556 (1908): "Manufacture implies a change, but every change is not manufacture, and yet every change in an article is the result of treatment, labor, and manipulation. But something more is necessary .... There must be transformation; a new and different article must emerge, 'having a distinctive name, character, or use.' ... a person who makes only minor alterations to a product, which do not affect the basic nature of the product, is not engaged in manufacturing." As T did not cause the computer hardware to be transformed into a new and different item or make it suitable for a different use, T was not engaged in manufacturing.

The Service also did not find that design, development and loading of software constituted manufacturing. It relied on a state decision—*First Data Corp.*, 357 N.E.2d 933 (MA 1976). First Data operated a commercial, online computer time-sharing system. The court held that the transmission or manipulation of knowledge or intelligence did not constitute manufacturing.

**Proposed §460 Regulations:** In May 1999, REG-208156-91 was issued to replace most of Notice 88-99 once finalized. These regulations define and explain "long-term contract," start and completion dates, severing and aggregation of contracts, related party issues, "unique" items, excluded contracts, operation of the percentage-of-completion method, and relationship to AMT.

**24. Patent Infringement Damages Do Not Qualify for §1341 Treatment**—TAM 199923003—T manufactured and sold inventory. Plaintiff [P] brought a patent infringement suit against T and the court found against T. T was ordered to pay damages under 35 U.S.C. 284 to compensate for the infringement. In the year T paid the damages, it applied §1341 and the Service disallowed such treatment. The Service noted that a difference exists between "a patent holder's 'damages' and an infringer's 'profits.'" The Service noted that the item restored by T was not the same item it previously included in income.

**25. California Research Credit**—SB 705, signed by the Governor on July 7, 1999 (Chapter 77) increases the California research tax credit from 11% to 12% for tax years beginning on or after 1/1/99.

**26. Property Tax and Software**—In *Hahn v. SBE*, 1999 Cal. App. LEXIS 694 (Ct. App., 2d Appellate, 7/99), the court upheld the lower court's determination that a 1996 SBE amendment to Rule 152 was valid. A group of county assessors challenged the 1996 change as creating a new property tax exemption which can only be done by the Legislature, not by the SBE. Rule 152 interprets R&T §995 as created in 1972. Basically, these provisions were interpreted for over 20 years as only causing basic operational programs bundled with hardware as subject to property taxation. Per §995: "storage media for computer programs shall be valued ... as if there were no computer program on such media except basic operational programs. Otherwise, computer programs shall not be valued for purpose of property taxation." In 1995, the Orange County Assessor's Office assessed IBM as the licensor of computer programs licensed to Orange County customers even though IBM was not the owner or possessor of the related storage media. The SBE then conducted hearings to better understand the issue. In 1996, the SBE amended Rule 152 to state that "the term 'basic operational program' refers to a 'control program' as defined in section 995.2 ..., that is included in the sale or lease price of the computer equipment. A program is included in the sale or lease price of computer equipment if (i) the equipment and the program are sold or leased at a single price, or (ii) the purchase or lease documents set forth separate prices for the equipment and the program, but the program may not be accepted or rejected at the option of the customer."

The court examined the legislative history to §995 and found that in 1972, bundled programs were being valued along with the hardware and the legislature intended to maintain this system under §995, but not to tax any other programs. The court found that the 1996 amendment to Rule 152 was within the intent of §995 and 995.2, and thus the SBE was acting within its scope of duty to prescribe rules and regulations to govern assessors. The court noted that the "function" of software was never intended to be the defining point between taxable and non-taxable software. Instead, the intent was to continue the 1972 tax system and to tax only "bundled" basic operational programs. The case contains a good history to §995.

## Stock Investments

**27. California's §1202**—AB 1120 (Chapter 69; 7/6/99) makes California's version of the §1202 50% gain exclusion on qualified small business stock continue to apply. Prior to the change, R&T §18152.5 provided that QSBS had to be issued before January 1, 1999. The 1999 legislation removes the January 1 date.

**28. Warrants Related to Lease Financing**—Taxpayer (T) is a venture capital fund that provides lease financing to and buys equity interest in, emerging growth companies. Lessor Company (LR) assists T in these activities. A typical arrangement involves LR agreeing to lease property having a specified value to Lessee (LE), an emerging growth company. LR's lease obligations are assigned to and assumed by T. T receives, in exchange for cash, a warrant from LE which entitles T to purchase LE stock. In PLR 199927022, T sought a ruling as to the possible tax consequences of this leasing/financing arrangement. In the specific transaction described in the PLR, LR and LE entered into a lease arrangement which included an incentive for LR under which LE would grant a warrant to LR to purchase a specified number of LE shares at its initial offering price. The agreement stated that LR would assign the lease and the related property to T. Per T, the lease agreement provides for an arm's length return. T and LE entered into a warrant purchase agreement under which T agreed to buy from LE a warrant for \$B. This warrant entitled T to buy a specified number of shares of LE's Class 2 stock at a stated price. If the amount of lease financing exceeded a specified amount that was less than \$A (the value of the lease financing), the number of Class 2 shares that could be purchased at that price would increase proportionately up to a specified maximum amount. The warrant was exercisable at the earlier of a specified date or the fifth anniversary of the first IPO. When the warrant was issued the FMV of a share of LE Class 2 stock was less than the warrant's per share exercise price. Soon after LE's IPO, T fully exercised its right under the warrant, at a time when the FMV of LE stock greatly exceeded the warrant's per share exercise price.

The Service ruled that T's receipt of the warrant was a closed transaction because it had a FMV. T's basis in the warrant was equal to the amount it exchanged for it. In addition, T does not recognize income upon exercise of the warrant even though the then FMV of the Class 2 stock exceeded the warrant's exercise price.

**29. Is Revenue Ruling 71-52 Still Applicable?**—A fairly recent issue regarding ISOs and ESPPs involves whether a 1971 ruling is no longer applicable even though the Service has not officially revoked or superseded it. Rev. Rul. 71-52, 1971-1 C.B. 278, holds that the exercise of qualified stock options does not result in a payment of wages and thus, the employer is not liable for FICA or FUTA taxes or federal income tax withholding. However, the resulting income to an employee is reportable as "other compensation" on Form W-2 if it exceeds \$600 for the year, and on Form 1099 for a non-employee. This ruling was cited in several PLRs seeking approval that an employer's Employee Stock Purchase Plan (ESPP) was a valid plan under §423(a). For example, in PLR 8525084, the Service stated: "Based on Rev. Rul. 71-52, in the event that (a) a qualifying disposition of stock acquired under the Plan is made by an employee (i.e. having satisfied the holding period requirements of section 423(a) of the Code), (b) a disqualifying disposition of such stock is made by an employee (i.e. not having satisfied the holding period requirements of section 423(a) or (c) an employee dies at any time while owning such stock, amounts recognized by such employee as income with respect to the stock do not constitute "wages" for purposes of the [FICA, FUTA], and Collection of Income Tax at Source on Wages."

In Notice 87-49, 1987-2 C.B. 355, dealing with a change to §422A(b) by the TRA'86, the Service stated that they were "reconsidering Revenue Ruling 71-52. Until the results of such reconsideration are announced, the principles of that revenue ruling will apply to a disqualifying disposition of stock acquired by the exercise of an ISO. Pursuant to section 7805(b) of the Code, any determination that the gross income resulting from such a disqualifying disposition is wages for Federal employment tax purposes will be given prospective effect only."

In *Sun Microsystems Inc. v. Comm'r.*, T.C. Memo 1995-69, acq. 1997-2 C.B. 1, the court held that in computing the research tax credit, the taxpayer could treat the spread realized by research employees from the disqualifying disposition of an ISO as wages. The court based its holding primarily on the *Apple Computer* case (98 T.C. 232 (1992)) which held that the spread on non-qualified stock options constituted wages for research credit purposes. The court noted that once a disqualifying disposition occurs, the ISOs are equivalent to the non-qualified stock options in the *Apple* case for purposes of recognition of income and §162 purposes. The Service relied on Rev. Rul. 71-52 and Notice 87-49 to distinguish the non-qualified options from the disqualifying disposition of the ISOs and the court rejected the Service's analysis.

"[The Service's] position as expounded in Rev. Rul. 71-52, supra and Notice 87-49, supra, is totally unpersuasive. In the first place, each of these pronouncements was issued for specific purposes of

administrative convenience not related to the issue before us herein. In the second place, and more importantly, revenue rulings, to say nothing of lesser pronouncements such as notices, represent 'merely the opinion of a lawyer in the agency and must be accepted as such,' and are 'not binding on the ... courts.'"

IRS Publication 15-A, *Employer's Supplemental Tax Guide*, (Supplement to Circular E) states:

"Generally, [ISOs and ESPP] options are not taxable to the employee either when the options are granted or when they are exercised (unless the stock is disposed of in a disqualifying disposition). However, the spread (between the exercise price and fair market value of the stock at the time of exercise) on employee stock purchase plan options is subject to social security, Medicare, and Federal unemployment (FUTA) taxes when they are exercised." [Pub. 15-A (1/99 rev.) pages 11 - 12]

FSA 199926034—The Service concluded that the excess of the FMV of ESPP stock on the exercise date [date when employee uses his or her payroll deductions to purchase the stock at the specified offering period date and discount] over the option price constitutes wages for FICA purposes and constitutes a payment of wages. Following is the Service's rationale:

"[T]he court [in the *Sun* case] completely discredited Rev. Rul. 71-52; therefore, even assuming for the sake of argument that this ruling applies to ESPPs, the opinion nullifies any affect the ruling had. Third, the court found ISOs and ESPPs to be indistinguishable with respect to whether the compensatory amount is wages. Therefore, given the court's holding that the compensatory amount with respect to ISOs is wages, it follows that the compensatory amount with respect to ESPP options is wages for employment tax purposes."

The FSA also states that the Service's letter rulings dealing with ESPPs do not indicate an inconsistent position and that PLR 9243026 states that exercise of an option under an ESPP results in FICA tax on the difference between the option price and the FMV of the stock. In a footnote though, the Service indicates that PLR 8540042 takes a contrary position. However, the Service states: "Based upon the numerous rulings issued in recent years, it cannot [be] argued that the Service has changed its position with respect to ESPPs."

Query: Has Revenue Ruling 71-52 been repealed?

- Apparently yes, per Publication 15-A and FSA 199926034. But, how binding is an IRS publication and an FSA? Does the Service's acquiescence to the *Sun* case constitute repeal of the 1971 ruling? Also, is the Service correctly interpreting the judge's statement in the *Sun* case about Rev. Rul. 71-52? Basically, the judge decided not to rely on the ruling for two reasons: 1) it was issued for administrative convenience, and 2) IRS rulings are not binding on the court as they are the opinion of one of the parties before the court. Instead, the court decided the case primarily based on the *Apple Computer* case (98 T.C. 232 (1992)).
- The Service has proposed an adjustment to employment tax returns for at least one company with respect to income resulting from the exercise of an option granted under an ESPP (FICA tax issue) and disqualifying dispositions of stock with respect to an ESPP (income tax withholding issue). The Software Publishers Association (SPA) has posted this anonymous company's Notices of Proposed Adjustments at its web site at:

<http://www.siaa.net/ga/finance/espp.htm>

The Service position is that income from the exercise of an option granted under an ESPP meets the definition of wages under §3121(a) and §3306(b) and is thus subject to FICA and FUTA taxes. The taxpayer relying on Rev. Rul. 71-52, disagreed. The Service argued that Rev. Rul. 71-52 does not address ESPPs, but instead addresses qualified stock options (QSOs). The taxpayer argued that FICA tax couldn't apply because per §421, no income results from the exercise of an ESPP option. Again, the Service asserted that Rev. Rul. 71-52 does not apply to ESPPs. The taxpayer argued that per Notice 87-49, income from the disqualifying disposition of ISO stock is not subject to federal income tax withholding and that such a disposition is governed by §421 which is the same provision governing disqualifying dispositions of ESPP stock and since both are governed by the same Code provisions, the same treatment should apply. Finally, the Service disagreed with taxpayer's argument that if the Service's acquiescence to the *Sun* case resulted in the revocation of Rev. Rul. 71-52, such action did not occur until November 1997 (taxpayer's years under audit were 1994 to 1996). The Service responded by stating that since it doesn't find that Rev. Rul. 71-52 applies to ESPPs, any revocation of that ruling is not relevant.

Another Notice of Proposed Adjustment (NPA) posted at the SPA site, deals with the issue as to whether "an ISO disqualifying disposition prior to Nov. 10, 1997 [where] the taxpayer is using the spread to

increase its [sic] R&D credit, the spread will be subject to income tax withholding (but not FICA)." The Service notes in this NPA that in acquiescing to the *Sun* case, "we agree that RR 71-52 and Notice 87-49 are wrong." Apparently, for disqualifying dispositions after 11/9/97, FICA and FUTA taxes would apply per this position of the Service and its statement in Pub. 15A.

In February 1999, a petition was filed in the Federal Court of Claims by Micron Technology on the Service's position that the spread between the option price and FMV of the ESPP stock is subject to FICA taxes at the exercise date (but not federal income tax withholding). Micron also challenges the Service's position that for disqualifying dispositions, the spread between the option price and FMV is wages subject to federal income tax withholding (but not FICA or FUTA). Micron's position is that per §421(a), an employee has no income upon exercise of an ESPP option, and no income from a disqualifying disposition of ESPP stock. See Tax Analysts' 1999 CTF 12-10.

In August 1998, the SPA and Biotechnology Industry Organization sent a letter to Congresswoman Johnson of the Ways and Means Committee pointing out the above problem and asking for clarification from the IRS on the application of Rev. Rul. 71-52. In addition to the administrative issue of whether or not Revenue Ruling 71-52 has been repealed, SPA and BIO point out that wage withholding on the spread either when the stock is issued or when a disqualifying disposition has been made will likely cause many rank-and-file employees to forgo ESPP plans because of the immediate impact to their cash wages. In addition, SPA and BIO note the administrative difficulties of the Service's new position caused by the need to track when employees sell stock, which would likely cause small employers to avoid ESPPs.

**30. ISOs and AMT Rates**—The spread on the exercise of an ISO is subject to marginal AMT rates of either 26% or 28%, while the eventual (non-disqualifying) disposition for regular tax purposes is limited to a 20% rate. The minimum tax credit (MTC) generated by any AMT owed might not be fully realized for some taxpayers until years after the sale of the ISO stock. Is this the intent of Congress or is it an item (AMT preference for ISO spread upon exercise) that was overlooked when the capital gain tax rate was lowered in 1997?

**31. CRS Says Capital Gains Tax Rate Not Too Important to Innovation and Growth**—A 1/28/99 Congressional Research Service report, "Capital Gains Taxes, Innovation and Growth" includes the following summary:

The belief on the part of many venture capital advocates that the capital gains tax plays an important role developed because the slump and recovery in the venture capital market in the seventies and early eighties was associated with a rise and fall in the capital gains tax. More recent evidence, however, indicates that there is no apparent relationship between venture capital investments and the capital gains tax.

There are several reasons why the effect of capital gains taxes on growth through investment in firms would be expected to be small. First, most capital gains accrue to mature firms and real estate; only a small share is associated with small and new firms. Institutional investors not subject to the capital gains tax provide most formal venture capital. Secondly, a capital gains tax cut will not specifically favor this type of investment, but will benefit a wide range of investment opportunities. Indeed, it could actually discourage such investment by reducing the present differential tax benefit for new stock issues. Nor is the capital gains tax likely to be an efficient mechanism to encourage acquisition of skilled executives through stock options, since these stock options are often not subject to the capital gains tax and since only a tiny fraction of gains is associated with stock options.

It might be possible to devise more targeted provisions, although such provisions tend to be complex and may, themselves, be relatively unsuccessful in stimulating investment.

The report also notes that data indicates that the increase in the capital gains tax in 1986 was not associated with a decline in venture capital. The CRS authors speculate that this may be due to investments by institutional investors that are not subject to tax (in 1994, about 70% of venture capital came from pensions, foundations, endowments and foreign investors). In addition, the authors note that most capital gains arise from assets that are not associated with venture capital. Thus, a capital gains tax cut is unlikely to do much to spur venture capital investments.

## Worker Classification

**32. Microsoft and Temporary Workers**—On January 10, 2000, the U.S. Supreme Court denied cert to hear Microsoft's appeal of a 9<sup>th</sup> Circuit decision that held that workers reclassified as employees were entitled to participate in the company's ESPP. News reports have estimated that several thousand employees are thus entitled to some type of compensation for their exclusion from the ESPP.

**33. Worker Classification Simplification Proposal**—Two bills have been introduced in the 106th Congress that present quite different approaches to improving the worker classification area.

(1) S. 344, the Independent Contractor Simplification and Relief Act of 1999, proposes a safe harbor approach in lieu of the 20-factor test to determine whether a worker is a contractor. Under the safe harbor, a worker is a contractor if one of the following is satisfied,

1. the worker satisfies (A) through (D) below—

(A) the worker (i) has the ability to realize a profit or loss, (ii) agrees to perform services for a particular amount of time or to complete a specified result or task, and (iii) either (a) incurs unreimbursed expenses which are ordinary and necessary to the service provider's industry and which represent an amount equal to at least 2% of the service provider's AGI attributable to services performed under one or more contracts, or (b) has a significant investment in assets.

(B) the worker (i) has a principal place of business, (ii) does not primarily provide the service at a single service recipient's facilities, (iii) pays a fair market rent for the use of the service recipient's facilities, or (iv) operates primarily from equipment that was not supplied by the service recipient.

(C) the services are performed pursuant to a written contract that provides that the worker is not an employee.

(D) Forms 1099 are properly filed.

2. the worker satisfies (A) through (C) below—

(A) the services are performed pursuant to a written contract, which provides that the worker is not an employee.

(B) the worker (i) conducts business as a properly constituted corporation or LLC under state law, and (ii) does not receive from the service recipient or payor any benefits provided to employees by the service recipient.

(C) Forms 1099 and corporate or LLC income tax returns are properly filed.

Under safe harbor (2), the number of covered workers not treated as employees per (B) above for any calendar year may not exceed the greater of (I) 10 covered workers, or (II) a number equal to 3% of covered workers. A covered worker is an individual for whom the service recipient or payor paid employment taxes for all four quarters of the preceding calendar year.

S. 344 would also repeal Section 530(d) dealing with technical services workers, as added by TRA'86.

(2) H.R. 1525 takes the approach of stating that a worker is an employee unless specific requirements are met. H.R. 1525 provides that a worker is not an employee if (a) the worker has the right to control and direct the manner of and means used in providing services to the service recipient, (b) the worker makes substantially similar services available to others and is not precluded by the service recipient from soliciting other business, and (c) the worker has the potential to generate profit or loss and if the worker fails to perform is subject to liability to the service recipient for damages. H.R. 1525 would repeal the common law tests. Thus, there would be no guidelines or precedent on how the "control" test would be satisfied. H.R. 1525 would also repeal Section 530 and provide limits on retroactive employment tax reclassifications.

## State Nexus - Selected New Developments and Issues

**34. Agency Nexus**—In *Comptroller of the Treasury v. Furnitureland South Inc.*, C-97-37872 OC (Cir. Ct. Md 1999) the court found that both Furnitureland (F) and the company that delivered its furniture (R) were subject to use tax collection obligations in Maryland. While F sold furniture in all 50 states, it only had physical facilities in North Carolina. F sends no unsolicited promotional materials into Maryland. Most customers rely on F to make delivery arrangements. Prior to 1991, F made deliveries in North Carolina and other East Coast locations, but decided to have another company handle deliveries in the future. One reason for the change was to avoid use tax collection obligations in other states. F obtained advice from its tax advisors as to how to avoid use tax collection obligations. The result was that a separate delivery company was formed which never had

executives or shareholders in common with F. F loaned funds to R for formation and sold and assigned trucks to it. F also made many of the delivery arrangements for R. Not until 1998 did R have customers other than F. In addition to delivering furniture to Maryland customers, R sometimes set-up and repaired furniture for F. R also sometimes picked up furniture in Maryland for F to repair. R also kept certain items on the trucks, such as bed slats, to sell to customers when needed. Most R trucks displayed F advertising.

The court determined that under Maryland law, both F and R met the definition of a "vendor"—R directly, and F through R, acting as an agent of F. Since F advertised delivery and set-up, its relationship with R was crucial to its operations. The court also applied the four-part test of *Complete Auto Transit*, 97 S.Ct. 1076 (1977), to determine that there was no Commerce Clause problem with finding that both F and R were subject to use tax collection in Maryland. The frequency of R's contacts on F's behalf in Maryland satisfied the requirement that the tax be applied to an activity with a substantial nexus in the taxing state. The court did not find that R was a "common carrier," but was more of a personalized delivery service. R even charged F less than it charged other customers, in addition to providing services (set-up and repair) not commonly provided by a common carrier. The court found the second prong of the test - fair apportionment of the tax, to also be satisfied. The tax was internally consistent because Maryland was only seeking to have F and R collect the tax. The tax was externally consistent because Maryland exempts property from tax if it was paid to another state. The third prong was also satisfied - the tax does not discriminate against interstate commerce. Finally, the court found the tax to be fairly related to services provided by Maryland - fire protection, roads and schools for customers, and roads for R and F.

Observation: Assume that an Internet-based seller of computer games or software or other items deliverable electronically, provides ISP services (perhaps by using a third party ISP) to customers (and/or provides a "free" computer to customers). For states where the ISP has a physical presence, it would appear that the seller could be subject to use tax collection obligations (assuming the state subjects electronically delivered items to sales tax). Note that it is not clear whether the Internet Tax Freedom Act would ignore the ISP relationship in this fact pattern since there is a relationship between the seller and ISP that may go beyond what is exempted under the ITFA.

**35. Emerging Issues? - Stretching Affiliate Nexus Rulings**—In *Bloomingtondale's* (567 A.2d 773, Penn. 1989), Pennsylvania tried to get Bloomingtondale's By Mail, Ltd. (By Mail) to collect use tax from catalog sales delivered into the state. By Mail was formed as a wholly-owned subsidiary of Federated Department Stores, Inc. Federated is a Delaware corporation with headquarters in Ohio and with stores (Bloomingtondale's) in Pennsylvania. By Mail is a New York corporation with officers and directors in New York, Ohio, and Connecticut. It operates its nationwide mail order business from Virginia and a fulfillment center in Connecticut. Customer orders are received at one of these locations and shipped to the customer by U.S. mail or common carrier. By Mail customers may pay by various credit cards including a Bloomingtondale's card. Customers wanting to return merchandise, do so to By Mail. By Mail had customers in Pennsylvania but did not collect use tax from them because By Mail did not have a physical presence in that state.

The Pennsylvania Department of Revenue argued that By Mail had sufficient nexus with the state to enable the state to impose use tax collection obligations. State arguments included: i) there were at least two instances where By Mail customers were allowed to return merchandise to a Bloomingtondale's department store, ii) By Mail and Bloomingtondale's use the same advertising themes and motifs, and iii) By Mail's separate corporate existence from Bloomingtondale's department stores is a mere legal formality which should not control constitutional considerations, but should be treated as an agency relationship, such as in the *Scripto* case (362 U.S. 207 (1960)). The court discredited each of these arguments as follows: i) the two merchandise returns were "aberrations from normal practice," ii) similar advertising themes is not enough to constitute nexus, and iii) By Mail does not have agents acting on its behalf in Pennsylvania, as *Scripto* did by using independent contractors to solicit sales for the company.<sup>7</sup>

In *SFA Folio Collections v. Bannon*, 585 A.2d 666 (Conn 1991), cert. denied 501 U.S. 1223 (1991), the court stated:

"[T]he separate corporate entities or personalities of affiliated corporations will be recognized, absent illegitimate purposes, unless: '(a) the business transactions, property, employees, bank and other accounts and records are intermingled; (b) the formalities of separate corporate procedures for each corporation are

<sup>7</sup> Similarly, see *SFA Folio Collections, Inc. v. Bannon*, 585 A.2d 666 (Conn. 1991), cert. denied, 501 U.S. 1223 (1991), *SFA Folio Collections v. Tracy*, 652 N.E.2d 693 (S.Ct Ohio 1995), and *Bloomingtondale's v. Dept. of Revenue*, 567 A.2d 773, aff'd without opinion 591 A.2d 1047 (Penn. 1991), cert. denied, 504 U.S. 955 (1992).

not observed ... (c) the corporation is inadequately financed as a separate unit from the point of view of meeting its normal obligations ... (d) the respective enterprises are not held out to the public as separate enterprises; (e) the policies of the corporation are not directed to its own interests primarily but rather to those of the other corporation."

The court also noted the "fundamental principle underlying our system of taxation, namely, that 'taxpayers may arrange their affairs to minimize their tax liabilities. ... "Even as a part of a deliberate tax-avoidance strategy, the fact that Folio is incorporated as an entity separate from Saks-Stamford and Saks & Company does not, standing alone, permit a taxing authority to disregard Folio's corporate identity."

Affiliates and Web Order Sites—The conclusion of *Bloomingtondale's, supra*, and similar affiliate cases, seem to support the sales tax approach of some current Internet merchandising operations. For example, while the bookstore Barnes & Noble has physical locations in many states, it bases its use tax collection obligations on orders from its Web site based on the physical presence of its barnesandnoble.com subsidiary (in 1999, this subsidiary became a separate entity, but the bricks and mortar store owns a significant amount of the stock). This situation has received some attention in the press. For example, in 1997 Amazon.com Inc. alleged in a countersuit against Barnes & Noble that it was competing unfairly by not charging sales taxes on books ordered via its Web site.<sup>8</sup> Also, a *New York Times* story explored the retailing approaches of Barnes & Noble, Borders, and Macy's, and the apparent use tax and retailing theories taken by each.<sup>9</sup> For example, Barnes & Noble operates its Internet business through a subsidiary which only has a physical presence in New York, New Jersey, and Virginia, and thus, only collects use tax from customers in those states. Per the February 9, 1999 *NYT* article, Barnes & Noble attempts to limit the relationship between the physical stores of the parent and the Internet operations of its subsidiary in several ways. For example, except in the three states, the physical bookstores do not advertise the Web site or give refunds for books purchased through the Web site. A visit to the Barnesandnoble.com site (at 2/9/99) indicates that gift certificates purchased online may only be used online, and not at a Barnes & Noble retail store or through a catalog. Yet, the Web site does include a feature to assist a user in finding the location of the Barnes & Noble bookstore closest to him.

In contrast, according to the *NYT* article, Borders, which also operates its Internet business through a separate entity, does market its Web site in all of its stores. The return policy provided at the Borders.com Web site states that returns are to be sent to the fulfillment center in Tennessee. At 2/9/99, the Borders web page stated that books could also be returned to any Borders store within 30 days of the shipping date; this option has subsequently been eliminated.

The *NYT* article further noted that Macy's.com allows its customers to return purchases at its physical stores. Macy's business model appears to be one of integrating the Web site and the physical stores to provide broader customer service, regardless of tax consequences.

*Relevance to dealing with issues of taxation of e-commerce:* The degree of relationship between a parent company's physical operations and its Internet sales-based subsidiary that rises to the level of creating nexus may have to await a court's analysis and decision. Such nexus determinations are also quite fact specific and depend on whether the separate legal entities truly operate as separate entities (for example, is the Internet subsidiary billed for the costs a retail store incurs in letting a customer return goods to the physical store).

Cases involving sales assistance—There have been a few cases over the years where a seller with no business location, property, or employees in a state had contacts with individuals in a state who assisted with sales in some way. The most common fact pattern involved use of teachers to help an out-of-state bookseller obtain orders from children from a book catalog. The cases are split as to whether the teachers were agents of the seller such that substantial nexus existed to require the vendor to have to collect use tax from its customers. Several of these cases are summarized below, followed by a query as to how these cases apply to the sales associates program of Amazon.com where it pays commissions to operators of various web sites with which it has agreements.

*Scholastic Book Clubs, Inc. v. State Board of Equalization*, 207 Cal App 3d 734, 255 Cal Rptr 77 (CA Ct App, 1989)—Scholastic (S) had no physical presence or employees in California, yet was assessed use tax because the SBE found that S's use of teachers and librarians to solicit book orders created sufficient nexus with California. S periodically mailed catalogs to teachers and librarians who previously placed orders or requested

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<sup>8</sup> "Amazon Countersues Barnes & Noble, Says Rival Must Assess Tax," *The Wall Street Journal*, August 22, 1997, page B8.

<sup>9</sup> Bob Tedeschi, "Despite Reprieve, Tax Laws Complicate Internet Retailing," *The New York Times on the Web*, February 9, 1999.

catalogs. S also mailed catalogs to unnamed teachers ("3rd grade teacher at ..."). Participating teachers distribute the order sheets, collect payment, and distribute orders to students for S. Teachers and librarians can earn "bonus points" from participating in the ordering process.

The court relied on California R&T §6203 defining 'retailer engaged in business in this state' as including "any retailer having any representative, agent, salesman, canvasser, or solicitor operating in this state under the authority of the retailer or its subsidiary for the purpose of selling, delivering, or the taking of orders for any tangible personal property." The court stated that even though the teachers were not obligated to act, once they do, they are under S's authority (because they were not under anyone else's authority for the activity). Also, a written agreement is not needed to establish an agency relationship, but can instead be implied based on conduct and circumstances. Finally, S ratified the acts by accepting the orders.

The court found that the relationship between S and the teachers was similar to that in *Scripto* and that the teachers did more than the jobbers in *Scripto* did because they collected payment and distributed the merchandise to the customers. The court stated that S was "exploiting or enjoying the benefit of California's schools and employees to obtain sales." Thus, sufficient nexus was found to allow California to impose use tax collection responsibility on S.

In *Scholastic Book Clubs, Inc.*, 920 P.2d 947 (S Ct. Ks 1996), with a similar fact pattern, the court also concluded that S had a use tax obligation. S had argued that the teachers were acting on behalf of the students, rather than on behalf of S and that no agency relationship existed with the teachers because there was no expressed or implied contractual agreement. In addition, S argued that the teachers do not act under its authority because S denied entering into a relationship with the teachers. The Kansas tax agency argued that S both directs the teachers to act and accepts the benefits of their efforts and provides them bonus points for their services thereby establishing an agency relationship. The court found that an implied agency can exist from a party's words, conduct or other circumstances and that denial by the alleged principal is not sufficient to disprove an agency relationship. The court ruled that the teachers were acting under S's authority once the teachers begin to sell S's books and S accepted the orders. The court also found "substantial nexus" as required by the *Quill* decision, based on Kansas agency and tax law. The court also relied on the 1989 California decision involving S. In contrast, the court found that *Pledger v. Troll Book Clubs, Inc.*, 871 S.W.2d 389 (Ark. 1994) which held that a bookseller had no nexus in the state was different because agency law in Arkansas differed from that in Kansas.<sup>10</sup>

In contrast, at least two cases with facts similar to the California and Kansas cases involving Scholastic Books, found that the taxpayer did not have substantial nexus with the state and thus, the state could not impose use tax collection responsibilities on the taxpayer. *Pledger v. Troll Book Clubs, Inc.*, 871 S.W.2d 389 (S Ct. Ark. 1994), involved a New Jersey company that had no business location, property or employees in Arkansas. The bookselling arrangement was similar to that of Scholastic Books described earlier. The court found that the teachers were not agents of Troll. Under Arkansas law, an agency relationship can only be found if the agent is authorized to perform for and bind the principal and the principal has the right to control the agent. The court found that the 1989 *Scholastic Book* case decided in California was distinguishable because it was decided prior to the *Quill* decision and California agency law differed from that in Arkansas. California law allows an agency relationship to be implied retroactively by ratification, while Arkansas does not. A dissenting judge stated that once a teacher sends in an order, a contract has been formed between the teacher and Troll and a contract of agency exists.

In *Scholastic Book Clubs, Inc. v. State of Michigan, Dept. of Treasury*, 567 N.W.2d 692 (Ct. App. Mich. 1997), the court held that "the use of teachers, without more, does not establish a substantial nexus with, or physical presence in, this state." The court found that the teachers were not S's agents under Michigan law, primarily because the teachers have no authority to bind S and the teachers are under no obligation to participate in S's program. The court analogized the teachers to parents who order items for their children. Thus, the court concluded that S had no use tax collection obligation in Michigan.

*Use of "associates" to aid in the selling process*—Amazon.com has an "Associates Program" under which organizations may earn money through sales made at Amazon.com's site when it was linked to from the organization's web page. The relationship is started when the organization submits an application that is accepted by Amazon.com. Amazon.com provides some assistance with the linking arrangement for the organization's site. A link can be provided that leads to a letter from the president of Amazon.com stating that

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<sup>10</sup> Similarly, see *House of Lloyd v. Commonwealth of Pennsylvania*, 684 A.2d 213 (Pa. 1996), where nexus was found in a situation involving distributors of the taxpayer's products in the state.

they are pleased to have "organization" in the "family of Amazon.com associates" and that they will ship books and provide customer service for the orders. Amazon.com is solely responsible for processing all orders. The agreement spells out the terms for calculating referral fees that are paid on a quarterly basis, although fees of under \$100 are deferred to a subsequent quarter. The agreement states that no agency relationship is created and that the organization does not have any authority to make or accept any offers or representations on behalf of Amazon.com.

Query whether the Associates Program causes Amazon.com to have substantial nexus in the states in which it has associates? A factor that may indicate the existence of substantial nexus is that despite the disclaimer that associates are not agents, the course of dealing may indicate otherwise. The associate is operating within the guidelines of the agreement created by Amazon.com and facilitating an order for the company that might not otherwise have occurred. On the other hand, the associates do not serve as Amazon.com's sole access point to customers in the state because the customers, who are already Internet users, could go directly to the Amazon.com web site to place their order. Query whether the arrangement results in substantial presence in Washington for organizations using Amazon.com to assist customers of the organization's web site to purchase books.

## Internet Taxation Developments

**E-Commerce Taxation Web Site**—See link at [http://www.cob.sjsu.edu/facstaff/nellen\\_a/](http://www.cob.sjsu.edu/facstaff/nellen_a/)

### 36. Internet Tax Freedom Act (Federal)—Review and Update

#### Basics

The Federal Internet Tax Freedom Act (ITFA, P.L. 105-277, 10/21/98) imposes a 3-year moratorium (from 10/1/98 through 10/21/2001) on state and local taxes on Internet access, unless such tax was generally imposed and actually enforced before October 1, 1998.<sup>11</sup> The moratorium also applies to multiple<sup>12</sup> or discriminatory taxes<sup>13</sup> on e-commerce. Exceptions: (1) persons or entities who knowingly communicate via the Web in interstate or foreign commerce for commercial purposes, materials that is harmful to minors (with some exceptions), (2) Internet access provider who doesn't offer screening software to limit access to material that is harmful to minors.<sup>14</sup>

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<sup>11</sup> Some sponsors of the ITFA view it as a temporary moratorium and expect the Commission to recommend a permanent ban. In January 1999, S. 328 was introduced calling for a permanent moratorium (see later discussion under legislative proposals).

<sup>12</sup> A "multiple tax" is generally defined at §1104 of the ITFA as any tax imposed by a state or political subdivision of the state on "the same or essentially the same electronic commerce that is also subject to another tax imposed by another State or political subdivision thereof (whether or not at the same rate or on the same basis), without a credit (for example, a resale exemption certification for taxes paid in other jurisdictions." Multiple tax does not include a sales or use tax imposed by a state and one or more of its political subdivisions on the same e-commerce or a tax on persons engaged in e-commerce which also may have been subject to a sales or use tax thereon.

<sup>13</sup> "Discriminatory tax" has a lengthy definition at §1104 of the ITFA. The definition uses two separate focal points for the definition, with satisfaction of either leading to a conclusion that a tax is discriminatory. The first focal point looks at the "fairness" or "neutrality" of the tax, while the second focal point labels a tax as discriminatory if applied based on an overly broad definition of nexus. More specifically, the definition of "discriminatory tax" per the ITFA language follows:

"(A) any tax imposed by a State or political subdivision thereof on electronic commerce that-- (i) is not generally imposed and legally collectible by such State or such political subdivision on transactions involving similar property, goods, services, or information accomplished through other means; (ii) is not generally imposed and legally collectible at the same rate by such State or such political subdivision on transactions involving similar property, goods, services, or information accomplished through other means, unless the rate is lower as part of a phase-out of the tax over not more than a 5-year period; (iii) imposes an obligation to collect or pay the tax on a different person or entity than in the case of transactions involving similar property, goods, services, or information accomplished through other means; (iv) establishes a classification of Internet access service providers or online service providers for purposes of establishing a higher tax rate to be imposed on such providers than the tax rate generally applied to providers of similar information services delivered through other means." OR

"(B) any tax imposed by a State or political subdivision thereof, if-- (i) [except for grandfathered taxes], the sole ability to access a site on a remote seller's out-of-State computer server is considered a factor in determining a remote seller's tax collection obligation; or (ii) a provider of Internet access service or online services is deemed to be the agent of a remote seller for determining tax collection obligations solely as a result of-- (I) the display of a remote seller's information or content on the out-of-State computer server of a provider of Internet access service or online services; or (II) the processing of orders through the out-of-State computer server of a provider of Internet access service or online services."

<sup>14</sup> The exception to the moratorium would allow a state or local government to access a tax on certain entities, if otherwise permissible. It is probably unlikely that a state or local government would access such a tax under the exception to the moratorium due to the administrative difficulties of determining whether the entity is making available materials that are "harmful to minors." In addition, the constitutionality of this exception is questionable. The Communications Decency Act of 1996 enacted as part of the Telecommunications Act, was held to abridge freedom of speech protected by the First Amendment. One reason for finding the CDA to be unconstitutional was the vagueness of its terminology, such as "patently offensive." *Reno v. ACLU*, 521 U.S. \_\_\_, 117 S.Ct. 2329 (1997). Also, in *ACLU v. Reno*, 31 F. Supp 2d 473 (ED Pa 1999), the constitutionality of the Child Online Protection Act enacted on 10/21/98 was challenged. The court ruled that the federal government was enjoined from enforcing or prosecuting matters under the Act (the government has filed an appeal). As with the CDA, the court found that the COPA placed a burden on speech and other less restrictive means (such as filtering software) existed. In *Arkansas Writers' Project, Inc. v. Ragland*, 481 U.S. 221, 107 S.Ct. 1722 (1987), a law exempting only certain types of periodicals from sales tax was found to violate the First Amendment's freedom of the press guarantee. "[T]he basis on which Arkansas differentiates between magazines is particularly repugnant to First Amendment principles: a magazine's tax status depends entirely on its *content*. '[A]bove all else, the First Amendment means that government has no power to restrict expression because of its message, its ideas, its subject matter, or its content.'" A

The ITFA preserves state and local taxing authority to the extent the particular tax is not covered under the moratorium.

The ITFA also calls for formation of a 19-member Advisory Commission on Electronic Commerce. The members include the Commerce and Treasury secretaries, the U.S. Trade Representative, 8 people representing state and local governments (including one from a state with no sales tax), and 8 from e-commerce industries (including one small business representative). This group is to conduct a thorough study of all levels of tax with respect to e-commerce, including considerations of all types of remote commerce.

The duties of the Commission are quite broad as explained in the following excerpt from the ITFA.

(g) Duties of the Commission—

- (1) In general.--The Commission shall conduct a thorough study of Federal, State and local, and international taxation and tariff treatment of transactions using the Internet and Internet access and other comparable intrastate, interstate or international sales activities.
- (2) Issues to be studied.--The Commission may include in the study under subsection (a)--
  - (A) an examination of--
    - (i) barriers imposed in foreign markets on United States providers of property, goods, services, or information engaged in electronic commerce and on United States providers of telecommunications services; and
    - (ii) how the imposition of such barriers will affect United States consumers, the competitiveness of United States citizens providing property, goods, services, or information in foreign markets, and the growth and maturing of the Internet;
  - (B) an examination of the collection and administration of consumption taxes on electronic commerce in other countries and the United States, and the impact of such collection on the global economy, including an examination of the relationship between the collection and administration of such taxes when the transaction uses the Internet and when it does not;
  - (C) an examination of the impact of the Internet and Internet access (particularly voice transmission) on the revenue base for taxes imposed under section 4251 of the Internal Revenue Code of 1986;
  - (D) an examination of model State legislation that--
    - (i) would provide uniform definitions of categories of property, goods, service, or information subject to or exempt from sales and use taxes; and
    - (ii) would ensure that Internet access services, online services, and communications and transactions using the Internet, Internet access service, or online services would be treated in a tax and technologically neutral manner relative to other forms of remote sales;
  - (E) an examination of the effects of taxation, including the absence of taxation, on all interstate sales transactions, including transactions using the Internet, on retail businesses and on State and local governments, which examination may include a review of the efforts of State and local governments to collect sales and use taxes owed on in-State purchases from out-of-State sellers; and
  - (F) the examination of ways to simplify Federal and State and local taxes imposed on the provision of telecommunications services.
- (3) Effect on the communications act of 1934.--Nothing in this section shall include an examination of any fees or charges imposed by the Federal Communications Commission or States related to--
  - (A) obligations under the Communications Act of 1934 (47 U.S.C. 151 et seq.); or
  - (B) the implementation of the Telecommunications Act of 1996 (or of amendments made by that Act).

The Commission is directed to "ensure that its work does not undermine the efforts of the National Tax Association Communications and Electronic Commerce Tax Project" which began studying similar issues in late 1996.<sup>15</sup> The Commission ends and their report is due April 21, 2000. Thus, they have just 18 months to conduct the thorough study outlined above.

Unfortunately, due to lack of a mechanism to ensure that the Commission would have the balanced number of government and industry members, it ended up with nine industry reps and only seven from government - a

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constitutional challenge to the ITFA exception to the moratorium might focus on such issues as whether the exception was vague (and whether the definition of "material that is harmful to minors" provided in the ITFA removes any vagueness), whether there was a compelling interest in the classification, and whether freedom of the press arguments apply to the Internet. Section 1106 of Title *XII* to the ITFA and its related provisions provides that if any portion of "this title" is held by a court to violate any provision of the Constitution, the other provisions of that title are not to be considered as affected. The moratorium and its exceptions are in Title *XI*, although it seems that the intent of the severability clause at §1106 was to be broader (and the section-by-section analysis provided by the sponsor states this intent).

<sup>15</sup> This industry-government group was formed in late 1996 to address state and local tax issues of applying subnational taxes to e-commerce, and to reach consensus, possibly in the form of model legislation for states to adopt. The group consists of 16 people from industry, 16 from government and 7 "other" from universities, the ABA, and the AICPA. The work of this NTA group is being carried out through the following subcommittees: project scope, tax rates, tax base, sourcing transactions, filing simplifications, and other simplifications. Draft papers and background information on the project are available on the Internet at <http://www.taxadmin.org/nta/> and <http://www.nhdd.com/nta/ntaintro.htm>.

problem that has delayed the work of the commission, cutting into its already short existence. On March 2, 1999, the U.S. Conference of Mayors and the National Association of Counties announced that they intended to file a lawsuit on March 8, 1999 to prevent the AC-EC from meeting prior to resolving the issues of its makeup. NACO urged state and local government organizations to join county officials and mayors in forming a "State and Local Government Task Force on Fair and Equitable Taxation." The goal of this group is to make recommendations to Congress on simplifying state and local sales taxes so as to restore fairness between Main Street and remote sellers.<sup>16</sup> In March 1999, the Department of Justice announced that it would represent the ten defendants (all nine industry commissioners and Mr. Lebrun) because the Commission is serving a government function. Finally, in May 1999, the problem was resolved when Mr. Barksdale, CEO of Netscape (which was acquired by AOL) stepped down, enabling a government official to be appointed to balance the Commission. The lawsuits were then dropped and the first meeting was held on June 21 - 22, 1999 in Williamsburg, VA. Governor Gilmore was selected as the chair of the AC-EC.

The members of the Commission are, in addition to Commerce Secretary Daley, Treasury Secretary Rubin, and U.S. Trade Representative Barshefsky:

<u>Industry</u>	<u>Government</u>
C. Michael Armstrong, Chairman and CEO of AT&T	James Gilmore, Governor of Virginia
Grover Norquist, President of Americans for Tax Reform	Dean Andal, Vice-Chair, California State Board of Equalization
Richard Parsons, President of Time Warner	Paul Clinton Harris, Sr., Virginia Delegate
Robert Pittman, President and COO of AOL	Ron Kirk, Mayor of Dallas
David Pottruck, President & Co-CEO of Charles Schwab	Michael Leavitt, Governor of Utah
John Sidgmore, Vice-Chairman of MCI WorldCom	Eugene Lebrun, Partner in Lynn, Jackson, Shultz & Lebrun, P.C., and President of the National Conference of Commissioners on Uniform State Laws (NCCUSL)
Stanley Sokul, Independent Counsel for the Association for Interactive Media	Gary Locke, Governor of Washington
Ted Waitt, Chairman and CEO of Gateway 2000	Delna Jones, County Commissioner—Oregon

Legislation enacted along with the ITFA includes sense-of-congress declaration that the Internet should be free of foreign tariffs, trade barriers, and other restrictions. This declaration sets out the negotiating objectives for the U.S. which include accelerating growth of e-commerce by expanding market access opportunities for the exchange of goods, services, and digitized information. There is also a sense-of-Congress declaration that no new federal taxes should be imposed during the moratorium.

NOTE: A reading of the full text of the ITFA and related legislation is highly recommended.

State compliance? On February 16, 1999, the North Dakota House of Representatives passed an amendment to its Century Code to address taxes on telecommunications and for other purposes (HB 1108). This bill changes the definition of "telecommunications services" to include "Internet access service or similar service," for gross receipts tax purposes. Apparently, the legislators view this change as a technical correction to a 1997 law. The ITAA sent a letter to the North Dakota governor and senate legislators opposing the addition of ISPs and noting that it might violate the ITFA. ITAA also noted that per an April 1998 FCC report to Congress found telecommunications services and information services to be mutually exclusive, calling into question the expanded definition of HB 1108.<sup>17</sup> In April 1999, Governor Schafer vetoed this legislation. It was noted that the anticipated legal challenges would cost more than the expected \$200,000 of revenue over the next two years.<sup>18</sup>

Update on the AC-EC: The AC-EC first met in June 1999. Subsequent to that first meeting, a subgroup of commissioners - the Work Plan Subcommittee, drafted a list of five areas the AC-EC should address. These areas are:

- State and local tax issues, including nexus;

<sup>16</sup> "Counties Join Mayors In Threatening Litigation Over Internet Panel," State Tax Notes, 1999 STT 40-48. NACO 3/2/99 press release at [http://www.naco.org/pubs/releases/internet\\_tax.cfm](http://www.naco.org/pubs/releases/internet_tax.cfm).

<sup>17</sup> North Dakota HB 1108 and ITAA, <http://www.itaa.org/news/pr/pr19990305c.htm>.

<sup>18</sup> *New York Cybertimes*, April 20, 1999.

- The views of remote sellers of tangible and intangible products, and direct marketers, including issues between Main Street retailers and out-of-state vendors;
- The philosophy of consumer advocates and low-tax advocates, including simplification and the level of taxation;
- Taxation of Internet access and telecommunications; and
- International taxation.<sup>19</sup>

At its meeting in September in New York City, the AC-EC developed a list of 18 criteria for simplified application of sales tax to e-commerce. The criteria:<sup>20</sup>

1. How does this proposal fundamentally simplify the existing system of sales tax collection?
2. How does this proposal define, distinguish, and propose to tax information, digital goods, and services provided electronically over the Internet?
3. How does this proposal protect against onerous and/or multiple audits?
4. Does this proposal impose any taxes on Internet access or new taxes on Internet sales?
5. Does this proposal leave the net tax burden on consumers unchanged?
6. Does the proposal impose any tax, licensing or reporting requirement, collection obligation or other obligation or fee on parties other than those with a physical presence in a particular state or political subdivision?
7. What features of the proposal will impact the revenue base of federal, state, and local governments?
8. Does this proposal remove the financial, logistical, and administrative compliance burdens of sales and use tax collections from Sellers? Does the proposal include any special provisions with respect to small, medium-sized, or start-up businesses?
9. Does the proposal treat purchasers of like products or services in as like a manner as possible through the implementation of a policy or system that does not discriminate on the basis of how people buy?
10. Does the proposal discriminate against out-of-state or remote vendors or among different categories of such vendors?
11. How does this proposal affect U.S. global competitiveness and the ability of U.S. businesses to compete in a global marketplace?
12. Can this proposal be scaled to the international level?
13. How does this proposal conform to international tax systems, including those that are based on source rather than destination? Is this proposal harmonized with the tax systems of America's trading partners?
14. Is the proposal technologically feasible utilizing widely available software to enable tax collection? If so, what are the initial costs and the costs for required updates, and how is to bear those costs?
15. Does the proposal protect the privacy of purchasers?
16. Does this proposal respect the sovereignty of states and Native Americans?
17. How does this proposal treat local governments' autonomy and their ability to raise a greater or lesser amount of revenues depending on the needs and desires of their citizens?
18. Is the proposal constitutional?

At its December 1999 meeting in San Francisco, the AC-EC discussed some of the proposals for application of sales and use taxes to e-commerce. A list of some of these proposals is summarized next. A list of all proposals submitted to the AC-EC for the December 1999 meeting can be found at:

<http://www.ecommercecommission.org/proposal.htm>

The final meeting of the AC-EC is scheduled for March 20 and 21, 2000 in Dallas.

### **37. Proposals Related to Taxation of E-Commerce**

- a. Permanent Moratorium**—S. 328 (Senator Smith of New Hampshire) calls for a permanent moratorium. Per Senator Smith, "There are several reasons why we should refuse to transform the Internet into a pot of gold

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<sup>19</sup> "Federal Internet Subpanel Reaches Consensus on Focus Issues," 1999 STT 153-17 (8/9/99).

<sup>20</sup> The 18 criteria are taken verbatim from the AC-EC's "Invitation for Proposals" at <http://www.ecommercecommission.org/invite.htm>.

for state and local tax collectors." [Congr. Record 1/28/99] He notes that state and local governments have alternative options for raising revenue, many are running budget surpluses, "a tax on Internet shopping is really just another tax on the American consumer," "imposing yet another layer of taxes in cyberspace is simply unfair, especially because many Internet shoppers already pay shipping or handling costs," and new taxes on on-line sales could "stifle the development of Internet commerce."

Observation: Despite the implications from the comments accompanying introduction of S. 328, Senator Smith does not call for repeal of use taxes and does not address issues of neutrality between e-commerce and other types of commerce. Also, calls for a permanent moratorium do not explain why e-commerce should not be taxed or why subnational governments should not be encouraged to try to collect use tax on e-commerce retail sales, as this tax is not a new tax (although it is often referred to by politicians and reporters as a new tax). Finally, the ability of subnational governments to raise other revenues varies from state to state. In California, local governments face several obstacles to replacing an eroding sales tax base with other revenues (such as supermajority vote requirements). In addition, while the income tax is increasing in the current "boom economy," most local governments do not share in this windfall.

Query: Should a permanent moratorium be created as part of Title 4 of the U.S. Code, *Flag and Seal, Seat of Government, and the States*, as have some other federal prohibitions upon the states. For example, P.L. 104-95 (109 Stat. 979; 1/10/96), provided at 4 U.S.C. §114, that the States may not impose an income tax on retirement income of an individual who is not a resident or domiciliary of the state.

- b. Permanent and Expanded Moratorium**—S. 1611 (McCain) would a) make the moratorium permanent, b) expand the coverage of the moratorium to also include sales and use taxes for domestic or foreign goods or services acquired through e-commerce, and c) resolve that the U.S. representatives to the WTO and similar organizations advocate that e-commerce not be burdened by national or local regulations, taxation or imposition of tariffs. Senator McCain advocates that the Internet be a worldwide "tax-free zone." He notes that he invites those favoring a different approach to step forward with a good reason and approach justifying it. "I look forward to debate on what is a fair tax system in the United States, at both the national and state levels. However, while we continue that debate, we must also ensure that we do not perpetuate the problems currently ingrained in our tax system by applying them to the Internet." [Cong. Rec. 9/22/99]

H.R. 3252 (Kasich) - similar to S. 1611.

Observation: S. 1611 and H.R. 3252 are different from S. 328 because they would expand the moratorium to also include sales and use tax on electronic sales. They also differ from Governor Gilmore's proposal (see next) in that Gilmore's proposal only exempt remote business-to-consumer e-commerce from sales and use taxes, rather than all e-commerce. Thus, under S. 1611 and H.R. 3252, shopping malls could just install computers where customers could place their orders and pick up the merchandise at the store - with no sales tax owed.

- c. No Taxation on Remote E-Commerce**—Governor Gilmore (Virginia), chair of the ACEC, proposes to ban all sales taxes on Internet sales and services, as well as the telephone excise tax. The sales tax ban would only apply to remote business-to-consumer sales. Lost funds would be replaced using a new 1% tax on phone service that would be distributed to state and local governments. States would be encouraged to simplify their tax rules. In addition, international sales taxes and tariffs on e-commerce would be opposed. Finally, states would be allowed to use excess federal welfare dollars to purchase computers and Internet access for poor families.<sup>21</sup>

Query: How is neutrality achieved if buying something on the Internet becomes cheaper than from a bricks and mortar store? What is the impact to state and local tax bases?

- d. Trusted Third Party/Keep Quill Approach**—Governor Leavitt (Utah), member of the ACEC, proposes to move towards collection of sales tax on all sales. His plan includes use of technology within a unified system that also involves a trusted third party (TTP), such as a credit card company. A justification for the TPP is to maintain taxpayer privacy by not having the customer have to disclose information to the government. This would level the playing field by treating the customer like one who goes into a retail store and pays cash (no personal data need be collected to tax the transaction). The National Governors' Association (NGA) endorses this proposal.

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<sup>21</sup> John Simons, "Ban on E-Commerce Taxes Urged by Panel Chief," *Wall Street Journal*, 11/10/99, B8.

Observation: The apparent goal of this proposal is to make it so attractive to use the TTP approach, that vendors who presently do not collect tax in all states will adopt it and use tax will then get collected. However, due to price competition faced by many Internet vendors and the ease of operating an Internet business with few physical locations makes this presumption questionable.

**e. Update and Expand P.L. 86-272 Approach**—Dean Andal, member of the ACEC and California Board of Equalization, calls for a uniform national standard for taxing e-commerce that requires a substantial physical presence. Mr. Andal would modify P.L. 86-272 to limit the types of activities that can create nexus and to expand the types of taxes covered.

Query: Since the e-commerce model is one where a business needs very few physical locations to reach customers in many jurisdictions, a physical presence nexus standard decreases the number of locations where sellers would have to collect use tax. How will states be able to collect this tax from the buyers?

**f. Ban on International Taxes and Tariffs**—H. Con. Res. 190 was introduced in September 1990 by Congressman Cox and Wyden of ITFA fame. This resolution urges the President to "seek a global consensus supporting (A) a permanent international ban on tariffs on electronic commerce; and (B) an international ban on special, multiple, and discriminatory taxation of electronic commerce and the Internet." It also urges the President to oppose any proposal by the United Nations or any country for a bit tax on electronic transmissions. H.Con. Res. 190 was passed by the House on October 26, 1999 (423-1) and was agreed to by the Senate on November 19, 1999.

**g. National Tax Approach**—S. 1433, the Sales Tax Safety Net and Teacher Funding Act, proposes to impose a federal 5% tax on retail sales of merchandise via the Internet or mail order. A credit would be available (not to exceed 5%) for state and local sales tax paid by the buyer on the goods. The revenue collected would go to a trust fund to assist states in compensating teachers.

**38. Compliance Study by IRS Buffalo District**—This district identified 18,000 commercial web sites to study, selecting 429 for audit. One of the preliminary findings is that for about 10% of these sites, the beneficial owner could not be identified. The IRS also found that about 65% of the companies audited expensed the costs to develop their web site, which the IRS believes should have been capitalized and amortized. The IRS also found that some taxpayers are buying expensive fishing equipment from outside of the U.S. and avoiding excise taxes, with the problem due to the "disappearing middleman." Finally, the IRS found that some ISPs did not file tax returns.<sup>22</sup>

**39. National Tax Association (NTA) Communications and Electronic Commerce Tax Project**<sup>23</sup>—This industry-government group was formed in late 1996 to address state and local tax issues of applying subnational taxes to e-commerce, and to reach consensus, possibly in the form of model legislation for states to adopt. The group consists of 16 people from industry, 16 from government and 7 "other" from universities, the ABA, and the AICPA. The work of this NTA group is being carried out through the following subcommittees:

- Project scope
- Tax rates
- Tax base
- Sourcing transactions
- Filing simplifications
- Other simplifications

The federal Internet Tax Freedom Act provides that the Advisory Commission shall "to the extent possible, ensure that its work does not undermine the efforts" of the NTA E-Commerce group.

*Final Report:* In September 1999, the NTA group issued its final report. This report includes a very important caveat that "Nothing is agreed to until everything is agreed to." Thus, none of the preliminary conclusions noted in the report are to be considered final conclusions. Some of the significant preliminary recommendations or resolutions adopted, subject to the caveat, are,

- There should be one *rate* per state with some type of measure taken to "ensure protection and equitable distribution of revenues to local jurisdictions."

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<sup>22</sup> George Guttman, "IRS Studying E-Commerce Tax Problems," 1999 TNT 206-7.

<sup>23</sup> Draft papers and background information on the project are available on the Internet at <http://www.taxadmin.org/nta/> and <http://www.nhdd.com/nta/ntaintro.htm>.

- States should have the ability to set their own tax *base* (no uniform base should be prescribed for the states).
- Transactions should only be *sourced* to the state level, not to the local level. Sourcing should be on the destination basis. If sourcing information is not available, default rules, to be developed, should be followed.
- State and local sales and use tax *administrative* rules should be simplified. Possible approaches include better use of technology, creating uniform vendor registration and exemption forms.

The NTA group could not issue any resolution regarding telecommunication taxes because it could not agree on a definition of "telecommunications."

#### **40. American Electronics Association (AEA) Adopts Guiding Principles of Internet Taxation**

1. E-commerce should bear no greater tax burden than other forms of commerce.
2. Tax administration should be simplified, such as adopting one-rate per state.
3. The physical presence nexus standard should be retained and clarified through expansion of P.L. 86-272.
4. New specific taxes on e-commerce, such as bit taxes, should be avoided.
5. Tax issues must be considered within the global context.<sup>24</sup>

#### **41. State and Local Government Organizations Adopt Four Broad Principles of Internet Taxation**—The National League of Cities (NLC) reported that seven organizations representing state and local governments adopted the following principles:<sup>25</sup>

1. Competitive neutrality should exist in the marketplace.
2. An expanded duty to collect should be implemented.
3. Federal preemptions over state and local tax systems should be avoided.
4. Tax simplification and systems modernization should occur.

#### **42. E-Commerce Report of California Senate**—Some of the interesting aspects of this overview report to e-commerce and its tax issues include:<sup>26</sup>

- With improved technology, the State Board of Equalization (BOE) will have more sources of data on who owes tax.
- "By the middle of this decade, California residents were saving an estimated \$180 million to \$200 million yearly by avoiding use taxes on out-of-state mail-order purchases."
- "The BOE, in March of 1999, estimated an annual sales- and use-tax revenue loss in California of \$18.5 million based on its best estimate of 1998 e-commerce."

#### **43. New Efforts to Collect Use Tax**—Both Michigan and North Carolina began a process of educating taxpayers about the use tax and added lines to the personal income tax forms to collect it (Connecticut, Idaho, Indiana, Kentucky, Maine, and Wisconsin have been doing this for years—but, not California). The state of Michigan has information on its web page (<http://www.treas.state.mi.us/mitax/suw/useindex.htm>) explaining the use tax, that it has been around since the 1930s, and that it benefits schools, local and state services, and Michigan retailers. The site also lists companies that collect Michigan tax and states that if consumers order from them, their "responsibility it met." It also lists companies (both mail order and Internet ones) that do not collect Michigan tax with the caveat: "If you order from these companies you need to file and pay tax. Save your receipts!"

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<sup>24</sup> See [http://www.aeanet.org/aeenet/PublicPolicy/patxet0998\\_ecommerceprinciplespp1of2.htm](http://www.aeanet.org/aeenet/PublicPolicy/patxet0998_ecommerceprinciplespp1of2.htm).

<sup>25</sup> See <http://www.nlc.org/brooks.htm>.

<sup>26</sup> "Taxing Internet Sales and Access," Publication #99-1, Sept. 1999, <http://www.sen.ca.gov/sor/e-commerce.html>.

Observations: (1) What's likely to be the compliance level?

(2) Will the "burden" of keeping receipts cause individuals to encourage vendors to collect the tax instead?

(3) Will other states follow the current lead of these states?

(4) Additional options: (a) Maine approach—The Maine Individual Income Tax form includes a line for use tax. Per the instructions, if individuals do not know the exact amount of use tax they owe, they may either multiply their Maine adjusted gross income by .04% or use a table included in the instructions (which is based on the .04% figure). If a person owes use tax on items costing \$1,000 or more, he must add the tax on those items to the table amount. The instructions also note that the use tax may be reviewed and if more use tax is owed, an assessment of interest and penalty may apply. If a person does not owe use tax, she must enter zero on the appropriate line. If a person leaves the line blank, the appropriate amount of use tax will be added to his tax liability. (b) States could create policies whereby they don't buy from companies that don't collect use tax, in an effort to encourage them to voluntarily collect the tax. (c) Connecticut approach—In 1998, Connecticut passed Public Act 98-244 which authorizes the state's tax commissioner to enter into agreements with other states to collect use taxes on remote transactions. States that participate will receive up to 50% of the use tax collected.<sup>27</sup> (d) Compensate vendors—The cost of sales and use tax compliance for multistate vendors is high. Few states provide compensation to vendors to help offset the costs they incur in collecting the state's revenue. (e) Use of technology—For Internet purchases, e-tailers could be encouraged to include a link on the order page for consumers to indicate which state they live in. Clicking the state button would cause the consumer's credit card or whatever payment tool they are using for the purchase to also be charged for the use tax. Of course, this method might also lead people to prefer mail order over Web order and create difficulties for consumers and vendors in knowing which items in which states were subject to sales and use taxes. (f) Restore a federal deduction—The itemized deduction for state sales and use taxes was eliminated by the Tax Reform Act of 1986. Perhaps consumer reaction to paying the use tax would be less adverse if the tax were deductible on their federal income tax return (however, only about 32% of individuals itemized their deductions). (g) Convert the subnational tax into a federal tax with revenues to be returned to the state—This option would only apply to remote sales (e-commerce and mail order). (h) Other options?

(5) Advantages of the self-assessment approach:

- The use tax is already part of the law, it just doesn't have an effective collection system in most states, but most states have not made an effort to either collect it from consumers or to educate consumers as to the existence of the tax.
- Self-assessment on a state income tax form would enable states to collect use tax on purchases made from non-U.S. vendors.
- The administrative costs would be low and compliance costs would also be low, particularly if the Maine approach were used because consumers would only need to keep track of receipts for purchases over a certain dollar amount (unless they wanted to show that their purchases were less than the .04% amount).
- It may force states to simplify their laws so consumers can better determine which purchases are taxable and which are exempt.
- State and local revenues would increase without the need for Congress to overturn *Quill* (and consumers may pressure out-of-state vendors to collect the use tax for them).

Disadvantages of the self-assessment approach:

- Seven states do not have an income tax<sup>28</sup> and would need a separate form to collect the use tax from consumers.
- If states do not also audit the amounts reported, compliance may lessen.
- Public outcry may result from their new awareness of the use tax and lead to calls for repeal of the tax. Many years ago in California the SBE began to notify Californians returning from out of the country that they owed use tax on their purchase of tangible goods outside of the country that they brought home with them. Public outcry led to an exemption for items costing under \$400.

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<sup>27</sup> Doug Sheppard, "Connecticut Collection Initiative Targets Use Taxes," *State Tax Notes*, 1999 STT 53-6.

<sup>28</sup> Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming do not have state income taxes. Also, two states—New Hampshire and Tennessee only tax certain interest and dividend income and might have to also use a separate reporting form for some taxpayers.

Query: Would public outcry lead to efforts by state legislators to repeal the use tax or add a de minimis exemption, OR would it lead the public to demand that the out-of-state vendors they buy from to collect the use tax for them? The answer might depend on the process used to educate the public. For example, would the public understand the relationship between the sales and use tax and the importance of these taxes to state and local tax bases?

- It would require additional recordkeeping by consumers. If the Maine approach were used, it might force consumers to pay the stated percentage amount because it might be difficult for individuals to prove that their use tax liability is actually lower.
- Consumers may have difficulty determining which purchases are taxable and which are exempt.

**44. Minimal Tax Impact to State and Local Governments**—A June 1999 study concluded that 63% of business-to-consumer online sales were non-taxable (such as airline tickets, gambling, and interactive games). Of the remaining 37% of business-to-consumer sales, sales tax was paid on 4% (4% of the 100% of business-to-consumer sales), and 20% was a substitute for other remote sales for which no tax was collected, leaving 13% of total business-consumer sales untaxed. The study applied an average state and local sales tax rate of 6.5% to determine that the estimated sales tax loss was \$170 million for 1998, representing one-tenth of 1% of total state and local sales tax collections.<sup>29</sup>

Comment: While the current revenue loss is small, the expected growth of e-commerce will create a much larger loss. However, while losses are small is probably the best time to derive a solution. However, many of these problems, such as loss of state and local tax base and competitive disadvantages for main street retailers, were identified in an extensive report on state taxation of interstate commerce completed by Congress in 1965 (the "Willis" report). What has prevented these problems from being resolved in the past 35 years and can they be resolved now? Arguably, one stumbling block has been the inability of states, cities, counties and businesses to work effectively together to resolve issues, such as the complexity of the sales tax systems.

**45. Some Main Street Retailers Take Action**—The American Booksellers Association sent letters to state governors and sent a "Sales Tax Action Kit" to ABA members. The letters suggest that Amazon.com has nexus in states where it has "associates" participating in its Associates Program, and that barnesandnoble.com and Borders.com have such close connections to their parent corporations to have the same nexus (rather than only having nexus where the few physical locations of the internet companies are located).<sup>30</sup>

**46. OECD TAGs**—Following the October 1998 OECD conference in Ottawa, five *Technical Advisory Groups (TAGs)* were formed in the following areas: 1) technology, 2) professional data access, 3) consumption taxes, 4) business profits, and 5) income characterization. Each TAG will function for two years and includes individuals from OECD member countries, non-OECD countries and the private sector. The TAGs are to analyze tax issues in their particular area and work towards solutions.<sup>31</sup>

**47. OECD PE Proposal**—In September 1999, the OECD Working Party No. 1 on Tax Conventions and Related Questions issued a draft proposal on application of the permanent establishment definition (from Article 5 of the OECD Model Tax Convention) for e-commerce transactions.<sup>32</sup> The drafters did not propose any change to the definition of PE, because the Committee on Fiscal Affairs, to which it reports, has indicated that the existing definition is capable of being applied to e-commerce. In addition, a different working group is addressing the issue of how much income should be attributed to e-commerce operations carried on by a PE. Significant elements of the draft include:

- a. A web site cannot be a PE because it is not tangible.
- b. A business does not acquire a place of business merely by having its web site hosted by an ISP in a particular location because the "server and its location are not at the disposal of the enterprise, even if the enterprise has been able to decide that its web site should be hosted on that particular server." In addition, since the ISP cannot conclude contracts for the customer, they are not agents of the customer.

<sup>29</sup> Ernst & Young, *The Sky is Not Falling: Why State and Local Revenues Were Not Significantly Impacted by The Internet in 1998*, June 18, 1999.

<sup>30</sup> See <http://www.bookweb.org/news/pressroom/2304.html>.

<sup>31</sup> For more information and current status, see [http://www.oecd.org//daf/fa/e\\_com/tag.htm](http://www.oecd.org//daf/fa/e_com/tag.htm).

<sup>32</sup> 1999 WTD 189-16.

- c. "Automated equipment that does not require on-site human intervention for its operation may still constitute a permanent establishment."
- d. A server is only fixed if it is located at a particular place for a "sufficient period of time."

Observations: A server is not like a vending machine because for the vending machine, its location is key to serving customers. In contrast, a server could be moved to a neighboring country (or perhaps any country) and still serve customers as effectively. Thus, item (c) above may be problematic. Also, perhaps in the near future, servers will be on satellites. Finally, perhaps the OECD should also evaluate the relevance of PE applied in the e-commerce model with what makes sense economically and administratively.

**48. Additional Internet Taxation Reports**—In 1999, Ireland issued a report entitled *Electronic Commerce and the Irish Tax System*, and Australia issued *Tax and the Internet: Second Report*. Links to these reports can be found at Professor Nellen's web page noted at the beginning of this section.

**49. United Nation's Human Development Report**—In July 1999, the United Nations issued *Human Development Report 1999*. This report provides background to and solutions for dealing with various gaps that exist throughout the world, such as technology, wealth, and education. One solution offered for narrowing the technology gap is to create new funding mechanisms, such as a bit tax or a patent tax. These types of taxes would raise funds from people with the technology and could be used to help provide the benefits to a broader group. A press release about the report notes that a tax of 1¢ on every 100 e-mails would generate over \$70 billion per year.<sup>33</sup> A subsequent statement from the U.N. indicates that the "bit tax" example is an illustration and it has no power to tax.

## Selected International Taxation Developments and Issues

**50. International Tax Reform**—Senator Roth has called for a series of hearings to review international tax rules to better address our global economy. "We need to fundamentally rethink the tax code with a view to enhancing American competitiveness in the new global economy and helping the American workforce."<sup>34</sup> Roth has also noted the need for the tax rules to be in sync with our trade policies. The first hearing was held March 11, 1999. In addition, Treasury is conducting a study of Subpart F issues that was expected to be released in Summer 1999.

*Worldwide versus territorial*—Probably the most significant international tax reform that warrants discussion is whether the U.S. tax systems should be changed from a worldwide-based one to a territorial one. The proposals for major federal tax reform, such as the Arney flat tax (H.R. 1040) and national retail sales tax (H.R. 2001), call for a territorial tax system. However, this aspect of reform has not received much attention in the "flat tax" debate. Instead, the matter has been discussed in the tax press and raised at hearing held by Senator Roth. As the U.S. share of world GDP continues to decrease and the U.S. government works to reduce trade barriers, some find it more and more difficult to justify a worldwide tax system that serves to achieve a goal that U.S. companies not favor foreign investment solely for possible tax advantages (such as lower tax rates). At the Senate Finance Committee hearing on international tax reform held on March 11, 1999, the Chief Tax Counsel for DaimlerChrysler noted that because Chrysler is now a subsidiary of a German company, its international taxes have decreased because of certain anti-deferral rules and foreign tax credit limitation rules that exist in the U.S. and the fact that Germany has a territorial tax system.<sup>35</sup>

**51. FSC and WTO**—In November 1997, a complaint was filed with the WTO by the European Union charging that the FSC represents an unfair trade subsidy. In late July, the WTO issued a preliminary confidential report ruling against the FSC system. A final WTO report was issued in October 1999 and did not change the holding of the preliminary report. Appeals and cross-appeals have been filed by the U.S. and EU.

**52. APA Disclosure**—In 1996, The Bureau of National Affairs, Inc. (BNA) brought an action against the Service seeking public disclosure of all Advance Pricing Agreements (APAs). From the start of the APA

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<sup>33</sup> United Nations, *Human Development Report 1999*, page 108, and <http://www.undp.org/hdro/E3.html>.

<sup>34</sup> Address before the Forum on Taxation of U.S. Multinationals, 10/1/98, 98 TNI 192-24.

<sup>35</sup> "DaimlerChrysler Testimony at Finance Hearing on International Taxation," 98 TNT 48-46.

program, the Service's position has been that the APAs relate directly to a taxpayer's potential tax liability and are not subject to disclosure per §6103. BNA argues that the APAs should be available under the FOIA and that they are "written determinations" subject to disclosure per §6110. In January 1999, the Service concluded that the APAs fell under §6110 and issued Information Release 1999-05 to notify taxpayers of its new position and to provide taxpayers the benefits of the redaction process similar to that used for the release of private letter rulings. The Tax Relief Extension Act of 1999 (P.L. 106-170; December 17, 1999) treats APAs as confidential under §6103. The Act also requires Treasury to prepare an annual report on APAs no later than 90 days after the end of the calendar year. [See Act §521.]

- 53. §482 Developments and Issues**—(1) As required by Congress (P.L. 105-277), in June, the Service issued Publication 3218, *Report on the Application and Administration of Section 482*. The report indicates that the estimated annual tax gap caused by non-compliance with §482 is about \$2.8 billion. The report also restates the Service's 5-part §482 strategy: i) issue §482 guidance, ii) encourage compliance with the arm's length standard when the original return is filed such as by requiring contemporaneous documentation, and imposing penalties for noncompliance, iii) strengthening worldwide consensus on the arm's length standard, iv) encouraging use of the APA process, and v) coordinating litigation of §482 through the Chief Counsel office.<sup>36</sup>
- (2) Revised guidelines, *Development of IRC 482 Cases*, were added to the Internal Revenue Manual in May 1999 covering such items as when to bring an economist onto a case, and that there is no single correct transfer price.<sup>37</sup>
- (3) *Compaq Computer Corp. v. Comm'r.*, T.C. Memo 1999-220 - the Service's reallocation between Compaq and its Singapore sub was not upheld by the court because Compaq was able to show the court that arm's-length prices were used. Thus, the approximately \$75 million assessment for two years was eliminated.
- (4) Cost sharing and stock options—The Service is taking the position that operating expenses to be included in the cost sharing pool of operating expenses (§1.482-7(d)(1)) includes stock option compensation. Either the amount reported on the tax return should be used or some other reasonable value of the options. This issue is one of several §482 issues to be addressed in a docketed case, Seagate Technology (Successor in Interest to Seagate Peripherals, Inc. f/k/a Conner Peripherals, Inc., Docket No. 15086-98.<sup>38</sup> Apparently, the Service also believes that a large stock option deduction where the employee performed work related to a cost-sharing arrangement should not be fully deducted against U.S. income. Of course, not all stock option spread results in a tax deduction to the employer (for example, ISOs). Finally, the Service might analogize to the *Apple Computer* case which held that deductible wages from stock options could count in the research credit computation. Arguments against the Service position include: a) the stock option spread would not be included in any arm's length agreement, b) the stock option spread is not an "out-of-pocket" cost of the employer and a party to a cost-sharing agreement will not want to pay for non-cash expenses, and c) the holding in the *Apple Computer* case was a technical one in that once the wages were identified as falling under §3401, they met the definition of wages for purposes of calculating the research credit. As stated in the Seagate petition: "Parties dealing at arm's length do not include either the "economic value" of stock options at the time of grant or the spread between stock price and exercise price at the time of exercise as a cost or expense for which the recipient of a service will pay."
- (5) Senator Dorgan continues to argue that some foreign-owned multinationals and some U.S. controlled corporations do not pay U.S. tax even though they have billions of dollars of U.S. sales. He cites to studies indicating transfer pricing abuses are a major reason for paying no U.S. tax. A press release of May 11, 1999 from Senator Dorgan's office states that the "IRS lacks the resources to properly enforce tax laws on such transactions. As a member of the Senate Appropriates Committee, Dorgan said he would push for additional resources to help the IRS stop such massive tax avoidance schemes. He said he will also push for a new system of enforcing those tax laws, switching from the outdated "arm's length" pricing method to determine whether or not pricing in transactions between related companies is appropriate to a formulary apportionment method which states have used for years to apportion taxable income to various states."

**54. R&E Allocation**—FSA 199932021 involved a second tier subsidiary (C) located in Possession M that met the requirements of §936. In 1994 and 1995, C elected to use the profit split method to compute its intangible

<sup>36</sup> The report is available from Tax Analysts' at 1999 WTD 109-25.

<sup>37</sup> BNA Tax Management Weekly Report, 7/12/99, page 1091.

<sup>38</sup> See 98 PTT 40-11.

property income under §936(h). C's parent (B) conducted substantial product-related R&E in 1994 and 1995, some of which was reported as legally-mandated R&E. B elected to apportion its R&D expenses using the sales method. C took the position that none of B's R&D expenses were properly allocated or apportioned to covered sales of the affiliated group. Thus, C determined that its share of product area research under the cost-sharing method of §936(h)(5)(C) exceeded the R&D expenses allocated or apportioned under the primary profit split method. Thus, used the modified cost-sharing amount in its combined taxable income (CTI) computation. The IRS National Office ruled that C did not properly allocate and apportion R&D for purposes of determining its intangible property income. The Service also noted that C's share of CTI could be a negative amount that must be considered in the §936(a)(1) computation and can reduce qualified possession source investment income (QPSII).

FSA 199918027 involved the proper R&D allocation for a parent and 16 CFCs, only one of which engaged in any development or manufacturing activities. During the audit, P proposed to change its apportionment of R&D expenses to a modified gross sales method that does not consider the sales of its nonmanufacturing CFCs. The Service disagreed with this approach primarily owing to the sophisticated and complex nature and the integral role of intangible property in the service business of the CFCs.

**55. Hybrid Entities**—"Check-the-box" regulations issued in 1996 simplified the classification process for partnerships and other non-corporate entities by, in essence, allowing the taxpayer to state its own classification via a binding election. These rules apply for both domestic and foreign entities. In early 1998, the IRS issued Notice 98-11 stating that regulations would be issued to prevent the use of certain "hybrid branches" under subpart F. A hybrid branch is treated as a branch for U.S. tax purposes, but as a separate entity (such as a corporation) for foreign tax purposes. The regulations met with much controversy and the IRS repealed them along with Notice 98-11. In Notice 98-35, the IRS indicated that instead of issuing regulations on hybrid branches, it would issue regulations on hybrid transactions, some of which will result in current taxation (that is, no deferral of the foreign income of the foreign corporation). In February 1999, H.R. 672 was introduced to prohibit the IRS from issuing regulations on hybrid transactions. In July 1999, proposed regulations were issued on using hybrid entities to avoid subpart F income. These regulations are not effective though until five years after the regulations become final. Thus, sufficient time is being provided to allow for discussion of the concerns that caused the regulations to be issued, as well as the possible adverse impact on international competitiveness.

## Modernizing the Tax Law for Today's Economy and Technology

**56. Overview**—There are a variety of areas where our federal and state tax laws are likely out-of-date. The earlier discussion on nexus and e-commerce provides some examples where current tax rules do not neatly address taxation of e-commerce. Some of the areas where modernization is needed include:

- Coordination of trade policy with the tax law.
- Consideration as to whether a worldwide tax system remains appropriate today given the increased competition that U.S. multinationals face.
- Depreciable lives are often too long for certain assets, such as chip manufacturing equipment (currently 5).
- Guidance is lacking in several areas: §197 on amortization of intangibles, the application of §382, and characterization of revenue from software transactions (§1.861-18 does not apply to domestic transactions).

## Selected Non-Tax Developments and Considerations

Many of the developments, court cases, and new public laws described in this section stem from increased use of the Internet and e-mail, as well as the growing use of software as a service tool. Many of these developments are impediments to the growth of our networked economy and society. These non-tax developments are important to tax practitioners because they may impact how services are provided to clients, they provide benefits and detriments to clients, and indicate how attorneys and businesses might want to or need to be involved in legislative matters to help promote growth of Internet use and e-commerce.

**57. U.S. Commitment to Innovation Weakening**—A March 1999 report of the Council on Competitiveness uses an innovation index to illustrate that the U.S.'s potential to sustain productivity growth

and long-term competitiveness is not keeping pace with some other OECD economies. "The Index indicates that the United States may be living off historical assets that are not being renewed." The report identifies various "challenges" to the U.S. to improve its competitiveness position long-term. These challenges to address include shortages in our scientific and technical workforce, stagnant R&D investment at the federal level, and reduced public investment in the national innovation infrastructure. See [http://www.compete.org/bench/bench\\_exec.html](http://www.compete.org/bench/bench_exec.html).

**58. Unprepared Workforce**—AEA reports that the number of bachelor's degrees in the math/computer science field declined 29% between 1985 and 1995. Demand for computer engineers is expected to increase 109% from 1996 to 2006. AEA also notes that almost 50% of PhD's graduating in the U.S. in engineering are foreign nationals and this talent needs to be retained in the U.S. The report also notes that our K-12 system is not adequately preparing students in math and science skills to be able to compete in the workforce of the future.<sup>39</sup>

A 1998 report issued by the Hudson Institute estimates that between 220,000 to 400,000 high-tech-related jobs are vacant in the U.S. today and that of the estimated 1.3 million new high-tech jobs becoming available in the next ten years, we are only preparing a small number of needed workers.<sup>40</sup>

**59. Digital Divide**—The Department of Commerce released, *Falling Through the Net: Defining the Digital Divide*, which provides information on the growing gaps between the "haves" and "have-nots" in terms of Internet usage and access. The report points out the gap between high income and low income individuals, as well as the racial divide finding that Black and Hispanic households are 2/5 as likely to have access to the Internet at home as White households.<sup>41</sup>

Observation: The digital divide that exists with respect to income levels indicates that exempting Internet purchases from sales and use taxes creates a distributional impact. That is, the exemption will provide a larger benefit to higher income individuals.

**60. E-Rate**—H.R. 692 calls for repeal of the e-rate operated by the FCC which collects funds from phone companies for universal service for schools and libraries. The sponsor of the bill says that the e-rate is a hidden tax and that alternatives exist for getting technology into schools and libraries. Opponents of the e-rate often refer to it as the "Gore Tax."

In *Texas Office of Public Utility Counsel, et al. v. FCC and U.S.*, 1999 U.S. App. LEXIS 17941 (5th Cir.), the court mostly upheld the FCC's actions in implementing 47 U.S.C. §254 as added by the Telecommunications Act of 1996 which provided authority for the FCC to design a universal service program.

**61. Privacy**—Privacy remains a significant issue that prevents many Internet users from doing business online. The FTC has been encouraging companies to self-regulate in this area, and expressed particular concerns regarding the lack of privacy at many Web sites designed for children. The FTC suggests the following core principles for consumers: 1) they be given *notice* of an entity's information practices; 2) they be given *choice* as to how information collected from them or about them is used, 3) they be given *access* to information about them that is collected and stored by an entity, 4) the data collector take appropriate steps to ensure the *security* and integrity of the information collected. A 1998 FTC survey indicated that about 85% of Web sites collect personal information from consumers with very few providing any information to users about the entity's use of the information. The FTC report noted that increasing concerns of consumers over online privacy would cause e-commerce to fail to reach its full potential.<sup>42</sup> Solutions to privacy concerns are relevant for tax purposes because such solutions may prevent the flow of information that would enable or simplify the collection of necessary tax information by the taxing agency and/or a vendor required to collect a tax.

The FTC actually brought a charge against GeoCities for allegedly misrepresenting the reasons why it was collecting personal identifying information from children and adults. This was the FTC's first Internet privacy

<sup>39</sup> AEA, "America's High-Tech Workforce—Supply of Workers Not Satisfying Industry Demand," June 1998, <http://www.aeanet.org/>.

<sup>40</sup> Carol D'Amico, "Got Skills," 1998, [http://www.hudson.org/American\\_Outlook/articles\\_fa98/damico.htm](http://www.hudson.org/American_Outlook/articles_fa98/damico.htm).

<sup>41</sup> See <http://www.ntia.doc.gov/ntiahome/digitaldivide/index.html>.

<sup>42</sup> Federal Trade Commission, "Privacy Online: A Report to Congress," June 1998; <http://www.ftc.gov/reports/privacy3/toc.htm>.

case and it was settled in February 1999. A consent order request GeoCities to place a prominent privacy notice on its Web sites, create a system to obtain parental consent prior to collecting personal information from children and to let individuals from whom it previously collected personal information an opportunity to have the information deleted.<sup>43</sup>

In October 1998, the European Union Directive on Personal Data became effective. The guidelines governing treatment of personal data are viewed by many as quite restrictive.

In March 1999, the Better Business Bureau OnLine (BBConLine) began a new privacy seal program for registered businesses. The seal tells users of a Web site how personal information is collected and used. The seal indicates that the site operators satisfy rigorous principles of notice, disclosure, choice and consent, access, and security.

*Private action versus government mandate:* In March 1999, IBM notified the operators of the Web sites at which it advertises that it would pull its ads if the operator did not have a clear privacy policy. IBM is the second largest advertiser on the Web (after Microsoft). In 1998, IBM spent \$45 million on Internet ads which was about 7% of its worldwide advertising budget; it expects to spend 10% in 1999. IBM discovered that only about 30% of the 800 Web sites at which it advertises had a clear privacy policy. IBM's logic behind its action is to promote growth of e-commerce by addressing a problem that consumers have with the Internet, namely, privacy.<sup>44</sup>

**62. Trying to Control Internet Gambling**—As in the 105th Congress (S. 474), Senator Kyl has introduced S. 692 in the 106th Congress to prohibit many forms of gambling on the Internet. S. 474 had passed in the Senate by a vote of 90-10, but was not completed in the House. Reasons cited by Senator Kyl for a prohibition include the attractiveness and ease access to gambling on the Internet for children and the addictiveness of gambling and its resulting costs and societal problems.

Query: How can a prohibition against gambling on the Internet be effectively enforced? If U.S. gambling establishments are restricted in some manner, gambler can find foreign gambling cites. Where should the line be drawn between self-regulation and government regulation? A similar issue arises with respect to congressional efforts, which have not been successful, to control access to materials "deemed harmful to youth" or "indecent" materials on the web. Many in Congress do not yet understand that "regulation" of the Internet can't be accomplished through the usual congressional approaches.

Example: Best Bet Sportsbook ([www.bestbetsports.com](http://www.bestbetsports.com)) is a Costa Rican company that offers Internet gambling. Its Web site notes that it does not report winnings to any government agencies and that it is the winner's responsibility to do so. In addition to wagering on sports games, this site offers wagers from \$1 to \$1,000 on whether the Dow Jones Industrial index will close either higher or lower in the next trading session. The company accepts American Express and Western Union "quick collect deposits."

**63. Trying to Control "Decency" on the Internet**—The same legislation that brought about the Internet Tax Freedom Act included the Child Online Protection Act (COPA). As noted earlier, the ITFA also tries to prohibit distribution of material "harmful to minors" by providing that the moratorium doesn't apply to such providers. In *ACLU v. Reno*, 31 F. Supp 2d 473 (ED Pa 1999), the constitutionality of COPA was challenged. The court ruled that the federal government was enjoined from enforcing or prosecuting matters under the Act (the government has filed an appeal). As with the Communications Decency Act,<sup>45</sup> the court found that the COPA placed a burden on speech and other less restrictive means (such as filtering software) existed. Some members of Congress continue to attempt varying types of regulation. For example, H.R. 368, H.R. 543, and S. 97 would require schools and libraries to install filtering technology in order to receive universal service assistance.

**64. Netiquette**—A June 1999 Canadian case denied plaintiff's request to have its e-mail account reactivated. P was sending 200,000 unsolicited e-mails (bulk) per day through the access provider's (ISP) Internet site, which was against the terms of the agreement between the parties. The ISP warned P that its account would be

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<sup>43</sup> FTC releases of 2/12/99 and 8/13/98; <http://www.ftc.gov/opa>.

<sup>44</sup> Jeri Clausing, "IBM Takes Stand for Consumer Privacy on Web," *New York Times* (Cybertimes), April 1, 1999.

<sup>45</sup> The Communications Decency Act of 1996 enacted as part of the Telecommunications Act, was held to abridge freedom of speech protected by the First Amendment. One reason for finding the CDA to be unconstitutional was the vagueness of its terminology, such as "patently offensive." *Reno v. ACLU*, 521 U.S. \_\_\_, 117 S.Ct. 2329 (1997).

deactivated if they continued to violate the contract. The contract stated that P agreed to follow generally accepted "Netiquette" when sending e-mail. P argued that bulk e-mail did not breach Netiquette, thus leaving the interpretation to the court. The judge reviewed articles on "spam" and the fact that it generated negative responses from the public to conclude that it was not an accepted Internet practice. The judge also referred to various U.S. cases dealing with account holder's right of expression and the distribution of junk e-mail. The judge concluded that based on emerging principles in American case law, reactions of individual Internet users and the fact that P could not find another ISP to permit it do distribute bulk e-mail, that sending out bulk unsolicited e-mail was contrary to Netiquette. [*1267623 Ontario Inc. v. Nexx Online Inc.*, O.J. No. 2246 (Ontario Sup Ct. 1999).]

Comments: (1) It is interesting that the Canadian judge relied on American case law to support the decision. Will use of opinions from other countries become more common as we deal with the borderless Internet?

(2) Does "Netiquette" need to be better defined? Should it become a legal term? Will professional organizations modify their rules of conduct to address Netiquette? Should they?

**65. Does Web Presence Create Jurisdiction?**—Over the past few years there have been several cases involving jurisdiction in non-tax situations, such as trademark infringement. Some of these cases are relevant to tax practitioners because in the absence of much case law dealing with taxes and jurisdiction (nexus), they provide some interesting points to consider both for jurisdiction and asset classification purposes, as illustrated in this article.

In *Panavision Int'l v. Toepfen*, 141 F.3d 1316 (9th Cir. 1998), T, an Illinois resident, had registered the domain name panavision.com and posted a picture of Pana, Illinois at the site. When P notified T that Panavision was a registered trademark, T tried to sell the name to P. P brought action against T in California on the basis that T had violated the Federal Trademark Dilution Act of 1995 and similar California law. The District Court held for P and T appealed. The Ninth Circuit affirmed. T's argument that California had no jurisdiction over him failed.

The court noted that where the only presence is through a web site, jurisdiction would only likely be found if there was "something more to indicate that the defendant purposefully (albeit electronically) directed his activity in a substantial way to the forum state." The court found that T had directed his activity (trying to obtain money from P) to California where P is headquartered. The court also stated that while T's burden of litigating in California is significant, it was not so great such as to deprive him of due process. The district court had even stated that due to fax machines and discount travel, litigating in California was not constitutionally unreasonable. The court also found with respect to the trademark dilution issue, T did make commercial use of the mark because he was in the business of registering trademarks as domain names and then selling them to their rightful owners.

In contrast, in *K.C.P.L., Inc. v. Nash*, 1998 U.S. Dist. LEXIS 18464 (SD NY 1998), the court held that New York did not have jurisdiction over an individual. While the plaintiff referred to the defendant as a cyber-pirate, the court noted that the defendant did not compare to Toepfen. Toepfen had registered over 100 domain names most of which were trademarks of others, while Nash had only registered four with just one of them a trademark, although the court noted it was not a famous one. Thus, the court could not find that Nash had transacted business in New York. The court also noted that the long-arm statute of California was not as restrictive as that of New York.

*Millennium Enterprises v. Millennium Music*, 33 F. Supp. 2d 907 (DC Or 1999), involved a situation that likely will become a common one when more "bricks and mortar" stores become "clicks and mortar" stores that serve customers both in person and via the Internet. As this occurs, many businesses will discover that their name is similar (or identical) to the name of a business located in another part of the country. Music Millennium (P), a retail music operation located in Oregon since 1969 brought a trademark infringement action against Millennium Music (D), a retail music operation in South Carolina. Both businesses had expanded to the web. For D, Internet sales represented a tiny fraction of its total sales and the only purchase by an Oregon resident was one made at the request of a friend of P's attorney to help establish jurisdiction in Oregon. One month after the suit was filed, D added a disclaimer to its web site indicating that its products were not available in Oregon.

The *Millennium* case includes a fairly comprehensive discussion of personal jurisdiction based on an Internet site and a review of the key cases in this area. The court noted that unlike a newspaper or television ad, most Internet ads are not directed at specific geographic groups. A review of recent cases indicated that just having a web site was not enough to find jurisdiction, but that "something more" was required to show that D purposefully directed its activities to the forum state (*Cybersell, Inc. v. Cybersell, Inc.*, 130 F.3d 414 (9th Cir. 1997)). However, the court noted that cases had not been decided consistently, particularly with respect to situations where the defendant's activities fell in between the spectrum of a passive web site which only

provides information and one where the defendant conducts business with visitors. Situations involving an interactive site where users may exchange information with the host computer fall in between these extremes and thus require "further inquiry into the 'level of interactivity and commercial nature of the exchange of information' to determine whether jurisdiction should be exercised" (quoting *Zippo Manufacturing Co. v. Zippo Dot Com*, 952 F. Supp. 1119, 1124 (W.D. Penn. 1997)). The court found that D made no deliberate and repeated contact with Oregon. It also noted that D's web site directed people to visit the physical store and was unlikely directed at people on the other side of the country. The court found that until D transacted business with Oregon residents or made some other contact, it was not subject to jurisdiction there.

*Relevance of the cases to tax nexus*—In *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992), the Court held that efforts to sell in a state (such as by mailing catalogs to residents) satisfied the due process requirement for jurisdiction. However, mailing catalogs may not equate to having a web site. For example, if a web site is selling regional merchandise (such as something related to a college or sports team in the area), yet anyone could order a product, has the business purposefully directed its activities to residents of every state? Or, is setting up a web site that does not prohibit customers in any particular state constitute directing activities to Internet users in all states?

The debate today over sales tax and e-commerce includes whether Congress should exercise its authority under the Commerce Clause and mandate that remote vendors collect sales and use taxes from customers. However, cases like *Millennium Enterprises* point out such action would not necessarily solve the tax collection problem because not all e-commerce vendors have purposefully availed themselves of a market in all states, thus leaving a due process issue to be resolved by state tax agencies and most likely, the courts.

*Relevance of the cases to taxation of the buyer and seller*—If Panavision had purchased the domain name from a third party, what type of asset would it be for tax purposes? Unlike the small registration fee which might be viewed as having only a two-year life because failure to re-register will result in loss of the name, the amount paid to the third party lasts as long as the name. Should such a payment be treated as a §197 intangible (as a trademark protection expense per Prop. Reg. §1.197-2(f)(3)(ii))? If not related to a trademark, does the asset fit within some other §197 category? Could the payment be expensed as extortion? What effect do renewals have on categorizing the asset? Perhaps the final §197 regulations will shed more light on these questions.

With respect to the seller, the domain name is not a capital asset if held by someone who is in the business of buying and selling domain names (as in the *Toeppen* case). That is, the asset likely falls within §1221(1) as property held primarily for sale to customers in the ordinary course of a trade or business. If a domain name was purchased for investment and the level of activity does not rise to the level of a trade or business,<sup>46</sup> then it must be determined if the name is a copyright, artistic composition, or similar property under §1221(3). Per §1.1221-1(c)(1), "similar property" refers to something that is eligible for copyright protection. The issue then falls under copyright law. Generally, words and phrases are not copyrightable because they do not have the minimal level of creativity.<sup>47</sup> But, if the owner's purpose of obtaining the domain name was the creativity of the name, might it be copyrightable? Resolution of this issue will likely first come from copyright cases, rather than tax cases.

In summary, tax practitioners serving clients with Internet operations will want to stay apprised of non-tax cases that are helping both to solve tax questions and to highlight tax issues.

*Libel*: In *Bochan v. La Fontaine and Harris*, 1999 U.S. Dist. LEXIS 8253 (ED Va 1999), individuals residing in Texas and New Mexico were found to be subject to the jurisdiction of the Virginia courts where the plaintiff bringing the libel suit resided. The alleged libelous statements were posted to a newsgroup and implied that plaintiff was a pedophile. Under Virginia law, the Texans were found to be subject to jurisdiction in Virginia because they used AOL, a Virginia company to post their messages which passed through property in Virginia. Thus, the court held that personal jurisdiction could be exercised over them because they had caused tortious injury by an act in the state. The person from New Mexico operated a business in that state which had a web site that solicited business from all over. The court found that even though no sale had been made to someone in Virginia, solicitation through an interactive web site was sufficient to find jurisdiction under Virginia law which provides that regularly soliciting business in the state makes someone subject to personal jurisdiction in the state.

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<sup>46</sup> There are several dealer versus investor cases under §1221(1), such as *Drummond v. Comm'r.*, T.C. Memo 1997-71 and *Guardian Ind. v. Comm'r.*, 97 T.C. 308 (1991), affd. without published opinion 21 F.3d 427 (6th Cir. 1994).

<sup>47</sup> See *CMM Cable Rep., Inc. v. Ocean Coast Properties, Inc.*, 97 F.3d 1504 (1st Cir. 1996), *Salinger v. Random House, Inc.*, 811 F.2d 90 (2d Cir. 1987), and cases cited therein.

Comment: The *Bochan* case is an interesting example and reminder of the public nature of Internet communications. Most likely, the defendants were not even thinking about any possibility of having a libel action in another state brought against them when they wrote a message and hit the "send" key. Law and accounting firms operating in a limited number of states, but with web pages that solicit business 24 hours a day throughout the world, should probably consider creating policies for use of the Internet by the firm and its employees so it best understands the wide consequences of various actions from answering e-mail questions to casual exchange of messages.

NOTE: Perkins Coie maintains a useful Web page with summaries of what seems to be all of the jurisdiction/venue cases involving the Internet. See <http://www.perkinscoie.com/resource/ecom/netcase/Cases-15.htm>.

**66. Location in Cyberspace**—A 1999 case involved the issue of where a person is "virtually" when she surfs the Internet. For example, if servers in Antigua are used by a New York resident to engage in on-line gambling, is that person gambling in New York (illegal) or in Antigua (legal)? In July 1999, a New York State Supreme Court judge ruled that the person is gambling in New York and the gaming company is, in effect, enabling the resident to gamble in a virtual casino in New York, which is illegal. The judge upheld the NY Attorney General's action to freeze \$800,000 in assets of the gaming company. While the Attorney General was unable to gamble when entering New York at the gaming site, it was allowed when he typed in Nevada.<sup>48</sup>

Queries: The on-line gambling scenario is one that challenges long-established theories of law and society. Governments regulate physical casinos, and expect to do the same on the Internet despite the difficulties of doing so. For example, how much verification should an on-line gaming provider seek to try to stay outside of states where gambling is illegal? A similar issue will exist when digitized products are provided over the Internet and governments expect the vendor to determine the state where sales tax should be collected (should the law ever be changed to overrule *Quill*). Also, should concepts of "presence" be revised on the Internet? Should we also assume that a vendor is present in a customer's computer, with such virtual presence sufficient to create tax obligations?

**67. Unauthorized Practice of Law Through Technology**—In *Unauthorized Practice of Law Committee v. Parsons Technology, Inc.*, 1999 U.S. Dist. LEXIS 813 (ND Tx 1999), the court held that Quicken Family Lawyer went beyond basic instructions for completing forms and was providing legal advice through its software, which was a violation of Texas law. While the QFL program included a disclaimer encouraging a user to consult a lawyer, that disclaimer only appeared upon initial installation of the program and not when the program did offer legal advice. The court noted that the types of questions asked by the program and the results produced created an "air of reliability about the documents, which increases the likelihood that an individual user will be misled into relying on them." The court rejected Parson's claim that a personal contact was necessary to violate the unauthorized practice of law statute and its claim that it had a constitutional right (1st amendment) to market QFL (the court held that the statute was aimed at the noncommunicative impact of Parson's speech and thus could generally be regulated in furtherance of a legitimate government interest).

Query: Are unauthorized practice of law statutes in need of modification in light of the ability of technology to perform analysis, and the public's desire for such assistance? Technology is allowing for removal of intermediaries (such as lawyers) in some transactions. Are new safeguards needed to enable more individuals to obtain affordable and appropriate legal assistance?

**68. GAAP & SEC Developments**—A variety of developments and issues have been raised in the past few years, including eliminating pooling in acquisitions and denying a write-off for in-process R&D. On July 28, 1999, the FASB announced that it would not currently pursue new accounting treatment for in-process R&D, but instead review a variety of R&D accounting matters. In the areas of stock option accounting, in March 1999, FASB issued an Exposure Draft that is a Proposed Interpretation of APB No. 25, *Accounting for Certain Transactions Involving Stock Compensation*. The comment deadline was June 30, 1999. An October 1999 tentative update can be found at <http://www.rutgers.edu/Accounting/raw/fasb/tech/index.html>.

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<sup>48</sup> Anthony Ramirez, "Judge Rules Internet Gambling Is Not Beyond Reach of State Authorities," *New York Times Cybertimes*, 7/27/99; World Interactive Gaming Corporation. Also see [http://www.oag.state.ny.us/press/1999/jul/jul26a\\_99.html](http://www.oag.state.ny.us/press/1999/jul/jul26a_99.html).

On August 12, 1999, the SEC issued Staff Accounting Bulletin (SAB) No. 99 addressing a new perspective on "materiality" in financial reporting. The SAB reiterates the view that materiality can not be solely a quantitative measure, but must consider all the relevant facts. One factor noted is the expected market reaction to an amount. Also, generally, misstatements should not be eliminated by other misstatements. Additional SABs issued in 1999 that may be of relevance to high tech companies include:

- No. 100—Restructuring and Impairment Charges
- No. 101—Revenue Recognition in Financial Statements

## **LOOKING AHEAD**

### **69. Depreciation Study**

The Tax and Trade Relief Extension Act of 1998 directs the Treasury to conduct a "comprehensive study of the recovery periods and depreciation methods" under §168 and to provide recommendations for determining these factors in a "more rational manner." The report is due to the tax-writing committees by March 31, 2000. Per the JCT report on 1998 tax legislation (JCS-6-98): "The Congress was concerned that the present-law depreciation rules may measure income improperly, may create competitive disadvantages, and may result in an inefficient allocation of investment capital in certain cases. The Congress believed that the manner in which recovery periods and methods are determined should be examined to determine if improvements could be made." [page 279]

Comments: For years, the chip manufacturing industry has tried to get the recovery period for its equipment reduced to a more realistic three years. Probably the main reason why such a change has not been made is finding a revenue offset. What is likely to come of this study if changes would result in a revenue loss? Should the study have also included §197?

### **70. Corporate Tax Shelters**

*Overview*—In the 1980s, use of tax shelters by middle- to high-income individuals was widespread. With tax rates as high as 70%, some individuals were eager to invest in real estate and other limited partnerships that produced interest expense and depreciation deductions. With the Tax Reform Act of 1986, Congress added a rule to only allow a deduction from a tax shelter (referred to in the law as a "passive activity") against income from a tax shelter. The result was that the shelter market for individuals ended. However, in recent years, there has been increased activity by some corporations to engage in financial transactions that appear to be done solely for tax purposes, rather than for business purposes. In 1997, Congress enacted a penalty provision for practitioners that market certain shelters. In 1999, President Clinton proposed 16 additional rules to further combat the spread of corporate tax shelters. While the 1997 provision is not currently effective, other penalties can apply. For example, in the *Compaq Computer* case, the court upheld the Service's assessment of a 20% negligence penalty.

*Nature of tax shelter transactions*—Several of the tax shelter cases have involved some type of financial instrument, such as American Depository Receipts (ADRs).<sup>49</sup> In addition, contingent installment sale rules have been used and often, a third party is involved in the transaction. There have also been several Field Service Advices (FSAs) issued by the Service that found various sales-leaseback transactions to be tax shelters.<sup>50</sup> Corporate tax shelters have been covered in some detail in the press. An article in *Forbes* magazine ("The Hustling of X-Rated Shelters," *Forbes*, 14 December 1998) highlighted the types of transactions some corporations were engaging in that posed audit risks and appeared to have no business purpose. After a few of the tax shelter cases were decided in late 1999, a *Business Week* article, "Kiss That Tax Shelter Goodbye?" (15 November 1999) noted that the tax court was being very tough on shelters. The article also noted that corporate taxes as a share of profits fell from 26.6% in 1994 to 21.8% in 1999.

*1997 Legislation and Treasury Study*—In 1997, Congress broadened the definition of a tax shelter and added a tax shelter registration requirement. Prior to this change, a tax shelter meant some type of entity or plan where the principal purpose was the avoidance or evasion of federal income taxes. The TRA'97 changed "the principal purpose" to "a significant purpose." As of 23 July 1999, no guidance has been issued under these changes. The registration requirements are not effective until regulations are issued. Apparently, the IRS is having difficulty separating "legitimate" tax shelters (such as corporate reorganizations and like-kind exchanges) from "bad" tax shelters. In July 1999, the Treasury Department released a report, *The Problem of Corporate Tax Shelters*:

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<sup>49</sup> For example, see *ACM Partnership*, 73 T.C.M. (CCH) 2189, aff'd in part, rev'd in part, 157 F.3d 231 (3d Cir. 1998), cert. denied, 119 S.Ct. 1251 (1999); *Compaq Computer*, 113 T.C. No. 17 (1999); *UPS*, T.C. Memo 1999-268; *IES Industries*, 84 AFTR2d 99-6445 (Dc IA 1999); and *Winn-Dixie Stores*, 113 T.C. No. 21 (1999).

<sup>50</sup> For example, see FSAs 199927039 and 199920012.

*Discussion, Analysis and Legislative Proposals.*<sup>51</sup> The Treasury Department would like to provide a "generic solution to curb the growth of corporate tax shelters" rather than just dealing with them after-the-fact. The report proposes the following definition of a "tax avoidance transaction" for which deductions, credits and exclusions could be denied.<sup>52</sup>

"A tax avoidance transaction would be defined as any transaction in which the reasonably expected pre-tax profit (determined on a present value basis, after taking into account foreign taxes as expenses and transaction costs) of the transaction are insignificant relative to the reasonably expected net tax benefits (i.e., tax benefits in excess of the tax liability arising from the transaction, determined on a present value basis) of such transaction. In addition, a tax avoidance transaction would be defined to cover transactions involving the improper elimination or significant reduction of tax on economic income.

A tax benefit would be defined to include a reduction, exclusion, avoidance or deferral of tax, or an increase in a refund, but would not include a tax benefit clearly contemplated by the applicable provision (taking into account the congressional purpose for such provision and the interaction of such provision with other provisions of the Code.)"

Also in July 1999, the Joint Committee on Taxation issued a legislatively-mandated report on penalty and interest provisions. This report also provides suggestions for using the penalty system to cut down on the proliferation of corporate tax shelters. Congress is expected to analyze the Treasury and Joint Committee on Taxation reports to determine what additional measures, if any, are warranted to address "abusive" corporate tax shelters.

*Reasons to disregard the transactions*—Courts have been able to, in effect, disallow a "tax shelter" using the economic substance and substance over form doctrines. The economic substance approach involves looking at the objective economic substance of the transaction along with the subjective non-tax business purpose. If a transaction is found to be devoid of economic substance, it is disregarded for tax purposes. Another approach to dismantling shelters is the step transaction approach where the total effect of all steps is considered rather than treating each as an isolated event. Additional theories that might be used to disregard the tax consequences of shelter transactions include the clear reflection of income standard (§446) and the income and expense reallocation ability of §482.

*President Clinton's 1999 proposals*—The 16 proposals include increasing penalties for substantial understatements of tax by corporations, increased disclosure of certain transactions, disallowance of a deduction for any fee paid to purchase a tax shelter, and imposition of a 25% excise tax on fees received for advising with respect to a corporate tax shelter.

*Practitioner reactions*—The Tax Section of the American Bar Association (ABA) presented testimony before the Senate Finance Committee on April 27, 1999 at a hearing on corporate tax shelters. The ABA expressed concern that in some tax shelter situations, taxpayers avoided penalties because they had favorable opinion letters from tax advisers. The ABA Tax Section has formed a task force to consider changes to its rules of conduct to address abusive situations. The Tax Section also expressed concern over the fact that typically the tax shelter transaction was treated differently for tax and financial reporting purposes, the sometimes secretive marketing of the shelters, and the fact that the Treasury tends to disallow the transaction prospectively only. The Tax Section also noted that problems in the tax law, such as its complexity, also needed to be addressed to reduce tax shelter activity.<sup>53</sup>

The American Institute of Certified Public Accountants (AICPA) testified before the House Ways and Means Committee on 10 March 1999 and expressed similar concerns and observations. The AICPA noted that taxpayers have the right to arrange their affairs so as to minimize their tax liabilities. Thus, any tax shelter proposals that limited the ability of taxpayers to engage in proper transactions would be inappropriate. The AICPA expressed concern "that increased and multiple penalties, based on a loosely defined standard and with

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<sup>51</sup> Available at <http://www.ustreas.gov/taxpolicy/>.

<sup>52</sup> U.S. Treasury Department, *The Problem of Corporate Tax Shelters*, July 1999, page 157.

<sup>53</sup> "ABA Offers Comments on Corporate Tax Shelter Problem," *Tax Notes*, 10 May 1999, page 919.

no abatement for reasonable cause, should not apply in a subjective area where differences of opinion are the norm, not the exception."<sup>54</sup>

**71. Guidance from Treasury & IRS**—There were many items on the 1999 Business Plan that were not issued in 1999, such as final §197 regulations. A few items were issued at the end of 1999, including Rev. Proc. 99-49, 1999-52 IRB \_\_\_, which replaces Rev. Proc. 98-60 on automatic accounting method changes, and Rev. Proc. 2000-11, 2000-3 IRB \_\_\_, which replaces Rev. Proc. 92-13 on accounting period changes.

The 2000 Business Plan should be issued in the first quarter of 2000.

## 72. FASB and SEC & The Internet

**a. Emerging Issues Task Force Inventory of Open Issues Relevant to Internet Transactions at November 1999**—In late 1999, the SEC sent a letter to the EITF listing several types of transactions of Internet companies and seeking guidance on how they should be reported. Several of these items are listed below. The status can be tracked at the FASB web site at <http://www.rutgers.edu/Accounting/raw/fasb/tech/index.html>.

- Issue No. 99-14, "Recognition of Losses on Firmly Committed Executory Contracts"
- Issue No. 99-17, "Accounting for Advertising Barter Transactions" Should these transactions be reported on the financial statements?\*
- Issue No. 99-19, "Reporting Revenue Gross versus Net" The issue is whether revenues from the sale of goods and services provided by third parties should be reported gross or net.\*
- Issue No. 99-O, "Accounting for the Costs of Developing a Web Site" One of the issues under review is whether SOP 98-1 on the treatment of internal use software should apply.
- Issue No. 99-P, "Application of AICPA Statement of Position 97-2, Software Revenue Recognition, to Arrangements That Include the Right to Use Software Stored on Another Entity's Hardware"
- Issue No. 99-V, Remaining Issues from the SEC's October 18, 1999 Letter to the EITF

\* A concern is that if revenues are overstated, the effect may be to artificially inflate the company's market capitalization.

**b. Exposure Draft Interpretation of APB #25, Accounting for Certain Transactions Involving Stock Compensation (March 1999)**—The final draft is expected to be released in the first quarter of 2000. For further information see <http://www.rutgers.edu/Accounting/raw/fasb/tech/index.html>.

## 73. Selected Tax Legislative Proposals of the 106th Congress

**a. Shorter Recovery Periods**—H.R. 1092 would shorten the recovery period for chip manufacturing equipment from five years to three years. H.R. 1122 and S. 635 would shorten the recovery period for printed wiring board and printed wiring assembly equipment to three years.

**b. Computer Donations**—S. 542 proposes to expand the incentive at §170(e)(6) for corporations to donate computers and software to K-12 by adding a tax credit for certain donations. The credit would be equal to 30% of the qualified contributions made during the year and 50% for contributions to schools in empowerment zones, enterprise communities and Indian reservations. The contribution deduction would be required to be reduced by the amount of the credit. The sponsors of the bill note that 32% of public schools only have one classroom with Internet access and that many schools have outdated equipment.

**c. For legislation related to the ITFA and taxation of e-commerce, see earlier section on Internet Taxation Developments.**

**d. 3% Telephone Excise Tax**—Senator McCain introduced S. 94 (106th Congress) calling for repeal of §4251 et seq. He notes that this tax was created 100 years ago on the "privilege" of using a phone. [Note: Others suggest that the tax is not this old.] He suggests that the budget surplus be used to pay for repeal. Per Senator

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<sup>54</sup> "AICPA Comments on Administration's Corporate Tax Shelter Proposals," *The Tax Adviser*, May 1999, page 346.

McCain: "the telephone excise tax isn't a harmless artifact from bygone days. It collects money for wars that are already over, and for budget deficits that no longer exist, from people who can least afford to spend it now and from people who are footing higher bills as a result of the 1996 Telecom Act implementation. That's unfair, that's wrong, and that must be stopped." [Cong. Rec. 1/19/99, S530] H.R. 1234 calls for the repeal of excise taxes on telephone and other communications services.

H.R. 727 (106th Congress) would retain the excise tax but dedicate the collections to a trust fund for support of universal telecommunications services.

*CRS Report:* In March 1999, the Congressional Research Service issued *Telephone Excise Tax*. The report notes that for FY1998, the 3% excise tax resulted in almost \$5 billion of revenues, all of which goes into the general fund. The report also clarifies the history of the tax which, while dating back to the Spanish War Act of 1898, was repealed and reinstated a few times, but has been in continually in existence since 1932. Its temporary, but renewed status, was changed when the Revenue Reconciliation Act of 1990 made the excise tax permanent. Finally, the report notes the following advantages and disadvantages of the telephone excise tax.

Advantages:

- While regressive, this effect is offset by the progressive income tax system.
- While the tax might no longer be needed to eliminate deficits, it can be used to reduce the debt.
- Administrative costs of collecting the tax are low because the cost is borne by the phone companies and evasion is difficult.

Disadvantages:

- The tax is regressive and hits more low-income families than do alcohol and tobacco excise taxes since 94% of households have a phone, but not all households purchase alcohol and tobacco products.
- The revenue opportunity should be reserved for the states rather than the federal government.
- Increased use of Internet telephony, which is not subject to the 3% excise tax, will cause competitive disadvantages with traditional phone service.

**e. Encryption and Tax Incentives**—H.R. 2617, the Tax Relief for Responsible Encryption Act of 1999, provides an incentive for software developers to include key recovery or similar "protections" in encrypted products. H.R. 2617 would provide a 15% tax credit for development costs of encryption products with plaintext capability without the user's knowledge (this includes key recovery). The credit would be allowed against both regular tax and AMT. Development costs would have to be reduced by the amount of the credit.

**f. President's FY2001 Budget**—Look for this in February 2000 and review the list of revenue provisions to see what final tax changes President Clinton would like to make.